LEGISLATIVE PROPOSALS TO INCREASE ACCESS TO CAPITAL

S. HRG. 115–354

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HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIFTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING LEGISLATIVE PROPOSALS ON CAPITAL FORMATION

JUNE 26, 2018

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C O N T E N T S

TUESDAY, JUNE 26, 2018

WITNESSES

Additional Material Supplied for the Record

LEGISLATIVE PROPOSALS TO INCREASE ACCESS TO CAPITAL

TUESDAY, JUNE 26, 2018

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. The Committee will come to order.

Today's hearing will focus on several legislative proposals that will encourage capital formation and reduce burdens for smaller businesses and communities.

My goal is to work with Senator Brown and other Members on this Committee to identify and move legislative proposals that achieve these aims.

Senators Schatz, Toomey, Heitkamp, and Tillis, among others, have cosponsored a bill that would make it easier for startup companies to tap the expertise and capital of angel investor groups.

Senators Toomey, Rounds, and Menendez, among others, introduced a bill that would provide more financing options for State and local governments seeking to raise money.

Senator Tillis has introduced a bipartisan bill that exempts emerging growth companies from certain auditor attestation requirements.

Senators Van Hollen and Tillis have cosponsored a bill that would encourage more public offerings by allowing all companies to "test the waters" prior to filing an IPO.

A bill introduced by Senators Kennedy and Jones would make it easier for investment advisers to focus on rural business investment companies.

Finally, Senators Cotton and Jones recently introduced a bill that will cut audit costs for noncustodial brokers.

These bills will improve companies' access to our capital markets and their ability to invest in the United States, in turn growing and creating jobs.

I look forward to hearing from our witnesses on these legislative proposals, and I now turn to Senator Brown.

OPENING STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman, and welcome to our witnesses.

I want to thank the Chairman for holding today's hearing and providing Members of this Committee the opportunity to discuss legislation that a number of my colleagues have worked on in this Congress.

Unfortunately, some of the bills we will discuss today, and at Thursday's hearing, undermine investor protections and transparency, and they potentially create risks to financial stability.

The ink is barely dry on S. 2155, the bill that rolls back many of the banking system protections developed following the financial crisis. And while Congress was working on that bill, the banking regulators, the newly installed banking regulators, many of them coming from Wall Street, began several efforts to weaken postcrisis safeguards. Now this Committee wants to work on bills that will undercut investor protections and market practices that have served to promote transparency. Lobbyists in this town just never get enough.

Several of today's bills have their roots in the JOBS Act and look to make changes that will supposedly increase capital formation or balance the number of IPOS back to levels from the 1990s—I am sorry, to boost the number of IPOs back to levels from the 1990s. I am concerned that more time is spent thinking about a JOBS Act 2.0 or 3.0 and finding laws that should be scaled back instead of trying to understand if the original JOBS Act actually created jobs.

I am sure we will hear about how each of today's bills is vital to help small companies grow and allow investors to participate in that growth. What we should also talk about is how Congress and the SEC can do more for investor protection and for market stability.

We do not spend enough time working to increase the public's trust in markets, but those efforts would benefit small companies and the jobs they create.

Earlier this year we heard from the SEC and the CFTC that keeping up with virtual currencies and related fraud was a tall order. But we know that low-tech fraud still exists.

Just yesterday, the *Wall Street Journal* reported that securities firms with high numbers of brokers with disciplinary records are selling tens of billions of dollars in private placements, specifically targeting seniors. We will hear more on Thursday about customers who are defrauded by their brokers, but the *Journal*'s findings indicate a serious problem facing savers: the allure of deals that are just too good to be true.

The SEC's recent settlement with Theranos shows how even sophisticated investors can have wool pulled over their eyes for years, and you read some of those names in the business section of the *Times* and the *Wall Street Journal* or any other papers, the *Financial Times*, and all over the last couple of years.

While the SEC continues to pursue fraud cases, the fact is enforcement cases and related penalties are down dramatically. Last week I sent SEC Chair Clayton a letter expressing my frustrations with the recent trends in enforcement. Yesterday's article shows that risks to investors are increasing in these good economic times.

The potential risks and potential negative consequences arising from today's bills are easily predictable. For example, a number of studies have shown that companies exempted from accounting requirements and auditor oversight of internal controls have higher rates of accounting restatements. It does not take a lot of imagination as to how that happens.

Maybe if we focused on passing laws that enhance investor confidence instead of undermining it, if we did that, this would end up helping businesses, too. After all, the more confident investors are, the easier it is for companies to raise money.

I have said before that protecting investors and strengthening the integrity of the markets is necessary for successful capital formation. And yet here we continue to consider bills that unwind many important safeguards, I think another example of collective amnesia that set in to this Congress. Slowly but surely, we will find that adding more exemptions and more carveouts has not had the desired result of more IPOs, but it has had a predictable result of denying investors key protections and eroding trust in the markets.

I look forward to hearing from our witnesses.

Chairman CRAPO. Thank you, Senator Brown.

Today's witnesses are Mr. Raymond J. Keating, chief economist of the Small Business and Entrepreneurship Council; Professor Mercer E. Bullard, Butler Snow Lecturer and professor of law at the University of Mississippi School of Law; and Mr. Chris Daniel, chief investment officer of the city of Albuquerque, New Mexico, on behalf of the Government Finance Officers Association.

We welcome all of you here. As I think you have been advised, your written testimony has been entered into the record, and we encourage you each to try to be very aware of the clock that is in front of you. We ask you to keep your initial remarks to 5 minutes, if you can, and then each of the Senators will have a 5-minute opportunity to engage you with questions. And at that point you can get out a lot that you did not get out in your other statements.

Also, I would ask you to recognize that the clock also runs on Senators, and when their questioning time is up, please try to bring your responses to an end promptly so we can get to the next Senator.

Mr. Keating, you may proceed.

STATEMENT OF RAYMOND J. KEATING, CHIEF ECONOMIST, SMALL BUSINESS AND ENTREPRENEURSHIP COUNCIL

Mr. KEATING. Chairman Crapo and Members of the Committee, thank you for hosting this important hearing today on the issue of access to capital. My name is Raymond Keating. I serve as chief economist for the Small Business and Entrepreneurship Council, a nonprofit, nonpartisan advocacy, research, and education organization dedicated to protecting small business and promoting entrepreneurship.

Throughout SBE Council's history, access to financial capital has been a core issue as it stands out as a foundational matter for entrepreneurs who are starting up, operating, or expanding businesses. However, for many entrepreneurs, gaining access to capital is a serious challenge.

During the financial crisis, the Great Recession, and an underperforming recovery, capital became difficult to access from institutional banks and various capital market players. And while matters have improved in recent years, many entrepreneurs continue to face challenges. For example, while growing since the recent low hit in 2013, the value of small business loans outstanding remains below the high hit in 2008. In effect, small business loan value has experienced no growth for more than a decade.

A similar trend and shortfall is seen in the number of small business loans with the level at the end of 2017 still below the 2008 level.

On the equity side, angel investment stands out as a critical source for funding startups in early stage businesses, but here the numbers have been disappointing in recent years. Postrecession growth was underwhelming, and since 2014, angel investment has, in effect, stagnated. And while not an option for most startups or very young firms, venture capital investment is an important avenue for innovative firms to raise capital for growth and expansion. The trend on the venture capital front after the recession thankfully tends to show more robust growth. Finally, there has been growth in online lending and crowdfunding for entrepreneurs as well.

So long after the financial crisis hit in late 2008 and the recession came to an official end in mid-2009, the financial capital story for the small business community has been mixed. While having recovered some, small business loans are still well off from where they should be. Angel investment in recent years largely seems stuck. Meanwhile, venture capital has shown, again, solid growth, while online lending and crowdfunding have opened new doors for many entrepreneurs seeking funding.

Assorted factors contribute to these trends, including the underperforming recovery—excuse me, underperforming economy over a period of a decade and a general decline in entrepreneurial activity.

Challenges among small community banks also have come into play given the important role that these institutions play in lending to small businesses. And community banking woes also tie back to the state of the economy, but to Government regulation as well, which always falls heaviest on small businesses.

Reform and relief efforts to clear away obstacles and reduce costs for lenders, investors, entrepreneurs and small businesses on the financial capital front are most welcome. SBE Council supports most of the measure being discussed today, namely, the HALOS Act, the Fostering Innovation Act, the Encouraging Public Offerings Act, the Small Business Audit Correction Act, and RBIC Advisers Relief Act, along with a host of other reform and relief measures mentioned in my written testimony.

Finally, when it comes to boosting access to capital for the entrepreneurial sector and thereby enhancing economic, income, and employment growth, SBE Council also looks in other areas such as taxation, and we favor, for example, reducing the capital gains tax and indexing gains for inflation. These measures, these other deregulation measures, enhance the returns on and incentives for investment and entrepreneurship.

Thank you for your time and attention, and I look forward to your questions and further discussion.

Chairman CRAPO. Thank you.

Professor Bullard.

STATEMENT OF MERCER E. BULLARD, BUTLER SNOW LECTURER AND PROFESSOR OF LAW, UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW

Mr. BULLARD. Thank you, Chairman Crapo, Ranking Member Brown, and Members of the Committee. It is an honor and privilege to appear before you again here today. I appreciate the opportunity.

This hearing will address a number of bills. At the moment I want to focus on those that relate to capital raising by U.S. companies. I would like to first address the premises underlying these bills and a fair amount of legislation over the last few years.

Capital market reforms have repeatedly been posed as solutions to the perceived problem of the decline in the number of U.S. IPOs and the number of U.S. public companies, and supporters often blame the decline on legislation that was enacted following two of the three worst downturns in U.S. markets since the Great Depression.

I have significant doubts about both premises. First, it is not possible to make a statistically meaningful connection between the Sarbanes–Oxley and Dodd–Frank Acts on the one hand and changes in the number of IPOs in U.S. companies on the other. The factors are too many and too diverse. Even if one could establish a relationship, the relationship would demonstrate that each act was followed by an increase in total capital represented by U.S. listed companies. The gross proceeds from IPOs during this century have substantially exceeded the amount raised in preceding periods, and 2018 is on pace to set a new record.

There is nothing inherently wrong with fewer IPOs and fewer public companies. In my opinion, these are the wrong measures. If Congress is concerned about the amount of capital raised in U.S. public markets, then it should consider the amount of capital raised in U.S. public markets, and in a century, the amount of capital raised in U.S. public markets represented by public companies has been a success story. The only short-term downturns have followed the Internet bubble and the Enron–WorldCom scandals and the financial crisis. The upward trend in total capital restored after the Sarbanes–Oxley and Dodd–Frank Acts became law. A U.S. listing is still the preferred worldwide standard. Among non-U.S. companies that choose to list outside their home country, U.S. exchanges are the overwhelming favorite.

In my opinion, capitalism is about increasing capital, not ensuring that regardless of the amount of capital raised, the capital will be more widely distributed. Capitalism is about the efficient allocation of capital, not ensuring that everyone gets a share regardless of the value of their enterprise.

I am also concerned about the continuing salt on the distinction between registered and unregistered offerings on which the Securities Act is based. The HALOS Act would allow virtually any type of public entity to advertise and host a public event that can be attended by any person for the purpose of any issuer pitching an unregistered securities offering. The act would permit public notices that specifically advertise the event as a forum for marketing securities. Congress calls this a clarification of what does not constitute a general solicitation, but a general solicitation is precisely what the event would be.

The HALOS Act effectively repeals offering regulation in the United States if that has not already occurred relative to the JOBS Act's permitting general solicitation and advertising in private offerings and $50 million Reg D offerings freed of State oversight.

The effective recent legislation in bills pending today is to make retail investors an informational underclass. Issuers are allowed to file confidential registration statements while distributing information to large investors in road shows for months, with the initial public registration statement being made available to retail investors just 15 days before the IPO. Issuers can raise capital from retail investors through crowdfunding, interstate, and Reg A offerings based on one set of information while they provide additional nonpublic information to wealthy investors under Reg D under terms that may dilute retail investors' interests. If information can be broadly and publicly disseminated to anyone and all offerings are essentially public in nature, then the terms of all offerings should be publicly available. If all offerings are to be public, then all private issuers should be required to make certain information publicly available on an ongoing basis, such as the terms in which past and current offers are made to investors and the amount of distributions made to investors. Instead, issuers of unregistered securities routinely ignore the minimal disclosure requirements to which they are subject. Many if not most Reg D issuers do not file Form D, and even that form is only a one-time filing that provides little useful information.

If ultimately any investor will be able to buy any security but only wealthy investors will be able to see confidential information and have far longer to consider an investment's prospects, Congress should consider what form of investor protection will take the place of the protections that have been and continue to be discarded.

I look forward to taking your questions.

Chairman CRAPO. Thank you.

Mr. Daniel.

STATEMENT OF CHRISTOPHER H. DANIEL, CHIEF INVESTMENT OFFICER, CITY OF ALBUQUERQUE, NEW MEXICO, ON BEHALF OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION

Mr. DANIEL. Chairman Crapo, Ranking Member Brown, and distinguished Members of the Committee, I am honored to be here today on behalf of the Government Finance Officers Association, GFOA, to share with you our comments in support of S. 1117, the Consumer Financial Choice and Capital Markets Protection Act of 2017, and its importance to public finance. My name is Chris Daniel, and I am the chief investment officer for the city of Albuquerque, New Mexico. I also serve on the Treasury and Investment Management Committee of the GFOA.

GFOA represents nearly 20,000 public finance officers from State and local governments, schools, and special districts throughout the United States. We appreciate this Committee's continued support for efforts to strengthen the municipal bond market, especially the recent enactment of legislation designating municipal securities as high-quality liquid assets. Such actions help States, local governments, and other governmental entities maintain access to low-cost capital, which is vital to infrastructure investment across the United States and contributes to a healthy and vibrant economy.

Likewise, money market funds are used by Governments as our leading vehicle for short-term investment of public funds. The SEC's change of net asset value, or NAV, accounting methodology from stable to floating negatively impacts our ability to use them. S. 1117 would restore the ability of State and local governments to safely invest in funds that meet the parameters of investment policies as determined by our own State and local elected officials, not by the SEC.

Let me provide the Committee with key concerns of Government finance officers as you consider this legislation to improve access to capital.

First, money market funds are used effectively to manage safety and liquidity for public sector investments. According to Federal Reserve data, State and local governments hold over $190 billion of assets in money market funds. Traditionally, Governments have used these funds to safely invest public monies as dictated within an entity's own investment policy. It is my experience that governing bodies approve a Government's investment policy based on industry best practices such as the GFOA's and the specific needs of the entity. Most Governments have policies demanding that the products used in their short-term investment portfolios have a stable NAV to maintain adequate levels of liquidity and safety through principal preservation. Requiring a floating NAV creates an unnecessary obstacle that has steered State and local governments into very low yielding U.S. Government-backed funds or other alternatives from what was already a safe and highly liquid market.

Second, money market funds provide access to working capital to fund public services and finance infrastructure investment. Money market funds are key purchasers of municipal securities. Historically, they have been the largest purchasers of short-term tax-exempt debt. The original objectives of the floating NAV rule change were to protect investors from runs on money market funds, but those concerns were already effectively addressed with the 2010 amendments to Rule 2a-7 following the financial crisis. GFOA and other State and local government issuer groups supported those amendments.

Despite the positive impact of the 2010 amendments, the SEC moved forward in adopting additional amendments to the rule in July 2014. Throughout that process, GFOA and public finance officers all over the country submitted analysis showing that a floating NAV would do little to deter heavy redemptions during a financial crisis and would instead impose substantial costs on State and local governments. That is exactly what happened. Between January 2016 and April 2018, tax-exempt money market fund assets under management fell by nearly 50 percent, from $254 billion to $135 billion, a dramatic shrinking of an important market for municipal debt. At the same time, municipalities issuing variable rate demand notes saw their borrowing costs increase significantly above the Federal Reserve's rate increases over the same period.

Many State and local governments opted to issue higher-cost fixed-rate bonds because issuing variable rate debt to money market funds has become impractical. In both cases, higher costs are being shouldered by taxpayers and ratepayers.

Public finance officers are encouraged by and support initiatives like S. 1117 which allow us to better serve our communities and provide important public services in a cost-effective way.

Thank you for the opportunity to speak to you today. I will be happy to answer any questions.

Chairman CRAPO. Thank you, Mr. Daniel. And I will start with you today.

Last week Ron Crane, who is Idaho's State treasurer, wrote about the additional costs and reduced incomes that the SEC's money market and mutual fund rule is imposing on State and local governments. He notes that the SEC's rule has caused more than $1 trillion of private sector liquidity to shift away from funds that invest in the economic infrastructure of our communities and into funds that invest strictly in the U.S. Government debt.

First of all, could you confirm that? And, second, can you talk about how S. 1117 will address those concerns?

Mr. DANIEL. Mr. Chairman, I can confirm that. State and local governments have a fiduciary obligation to taxpayers and ratepayers to preserve the public fisc. Rule 2a-7 hit local governments in two costly ways:

First, by floating the NAV, our statutes and policies restrict investment in these instruments, and we were forced out of the municipal money market and prime funds into very low yielding U.S. Government funds.

Second, by depleting these funds, short-term borrowing costs or rates on variable rate demand notes raised dramatically. Municipal governments like Albuquerque were forced into higher-cost fixed-rate debt in order to satisfy our working capital requirements. This solution is simply unsustainable.

S. 1117 will open back up the opportunity for investment in these financing and investment instruments. It will put another tool in the toolkit, if you will, for local governments to invest in a safe and adequately yielding instrument while providing a low-cost financing mechanism for short-term borrowing needs. S. 1117 will permit local governments to have the adequate and appropriate tools for local governments, both and small communities alike, to invest in infrastructure and maintain a healthy and vibrant economy.

Chairman CRAPO. And do you think that the outcome will increase risk in any aspect of this sector?

Mr. DANIEL. Mr. Chairman, I do not. The 2010 amendments to Rule 2a-7 dramatically increased the requirements for quality, maturity, and the like for municipal money market funds. Since 2010 there have been no dislocations of the capital markets until the SEC announced the 2014 amendments, which went into effect in October 2016. At that time over $1 trillion shifted out of prime- and tax-exempt funds to the Government funds. This is a market dislocation, but more important to us as medium and small local governments, it dried up access to short-term capital and caused us as investment officers to accept much lower return on our investments, as much as 30 basis points, which collectively amounts to $500 million in investment income we had lost that could be reinvested in our communities for public services.

Chairman CRAPO. Well, I thank you for that.

Mr. Keating, in your testimony you discussed trends regarding the availability of capital to small businesses. You note that small business lending has not recovered from the precrisis levels and angel investment has largely stagnated while venture capital has increased. S. 2155's commonsense reforms are intended to address some of this decline in small business lending postcrisis. What feedback have you received from your members about their access to capital and how it is impacting their ability to hire, grow, and innovate?

Mr. KEATING. Well, it depends on, again, the company, the industry, geographic location, and so on. But I think from what we have heard and from what you see in some of the polls, certainly small businesses are in a better position now than they were, say, you know, 4 or 5 years ago. However, there are still difficulties, and we certainly hear from members that are having problems in terms of getting small business loans, what other avenues can they go, can they go online, et cetera, et cetera.

So I think that, you know, the bill that you are talking about that was passed and signed into law makes sense because it deals with—when you are talking about community banks, small community banks, roughly half of small business loans come from those institutions. So when you look at the costs that a whole host of—that these regulations have hit these banks with—and I cite a couple of studies; I can give you more—any movement toward reining back excessive regulatory burdens and costs is not only good for those small banks, but it is good for the small business community in general.

Chairman CRAPO. Thank you.

Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

I think it is important to point out that, you know, loans were down from 10 years ago, but up from 9 years ago as the economy climbed back. So it is not entirely intellectually honest, I do not think, to only compare to what the economy looked like 10 years ago, because we know we have been fighting back. We also know we have had economic growth every quarter, every month, job growth every month since the auto rescue in 2010, and even though we had fewer jobs created in the private sector in 2017 than we did in previous Obama years, it is important to note that, I think.

Professor Bullard, your testimony explains the incoherence of the capital formation policies that Congress advanced in the past and now seems to be considering. I would like to focus on the risks to investors. What happens when companies use scaled-back auditing procedures?

Mr. BULLARD. Well, we have a lot literature on that, and it shows what you would expect. Companies that do not have the same level of auditing procedures have more restatements, but they also pay for it in the form of less reliable earnings, predictions, higher cost of private and public debt. There are studies that show that they have—that the auditors develop better information than management does internally. They also impose a higher standard for significant deficiencies and a higher standard for material misstatements. We know that the rate of intentional misstatements is higher for those low audit standards. And I think we would all understand intuitively obviously when you have got a cop on the watch, you are going to have better compliance going in, and you will detect a lot more miscompliance going forward. And that is what the data has pretty consistently shown.

Senator BROWN. So what does that mean? What are the risks of broadly advertising speculative early stage companies, as contemplated in the HALOS Act?

Mr. BULLARD. Well, we know very well not just from the *Wall Street Journal* article that came out the other day that private offerings have always been one of the favorites for brokers looking to maximize their compensation and in some cases committing fraud with respect to investors. And what we have seen over the years is the class of so-called accredited investors has increased exponentially. We have not really seen any catching up, in fact, a restriction, if anything, on the ability of States to enforce restrictions on offerings. And the key structure in the Securities Act when it was formed back in 1933 was based on the idea of offers being regulated because, as a practical matter, that is really the only way to regulate securities offerings before they have already been sold and investors have lost their money.

We have gone so far down the road through the JOBS Act that there really is not much left of offering regulation in that 1930s sense, and I think that if Congress is going to continue down that road, it really needs to think about a different way of looking at securities offering regulation. If it is going to be democratized in the sense of any issuer, any security, any investor, then, you know, what I see is this growing informational disadvantage that retail investors have, and that what we need is to have broader publicization of offerings to make them available at the retail——

Senator BROWN. That informational disadvantage is growing, and HALOS and other legislation Congress might be considering and rules from the Administration would accelerate that?

Mr. BULLARD. Yes. It is growing the private market because you have Reg A filings and crowdfunding filings that are publicly made and filed with the SEC. And then you have contemporaneous Reg D offerings where the investors and the crowdfunding and Reg A offerings, which are the retail investors, have no access to that information, and particularly do not have access to the terms being offered. So while in crowdfunding, for example, the SEC is allowing issuers to sell something that is called a "SAFE," when I think everyone in the rooms knows that crowdfunding securities are anything but safe, at the same time that issuer can offer better terms, not SAFEs, to Reg D investors.

On the public front, you really have a very extreme informational disadvantage. We saw this in connection with the Facebook offering when significant information came out 9 days before their IPO, and broker-dealers reportedly saw their institutional purchase base shrink as a result, and a bigger piece of that pie was provided to retail investors. And what Congress has done is essentially formalize that process by allowing those institutional investors, the wealthy investors, to receive information typically for months while the SEC peruses a confidential registration statement, and then that is put up on the SEC's site 15 days before the offering, and that is the entire amount of time that retail investors have to review it, which is pretty strikingly contrary to the fundamental relationship between information and public offerings in the Securities Act.

Senator BROWN. Mr. Daniel, I want to ask you a question—but my time has expired—about money market funds. I will submit it, and I hope you will respond to it quickly.

Thank you.

Chairman CRAPO. Thank you.

Senator Scott.

Senator SCOTT. Thank you, Mr. Chairman. Good morning to the panel. Thank you all for taking your time and making the investment to be here this morning.

In 1996, the American economy peaked with over 8,000 publicly traded company. As of today, that number is less than 4,300, about a 50 percent drop. In 2016, we saw just 112 public offerings, the lowest number since the financial crisis.

Some have suggested there is no reason to be alarmed for the demise of the IPO. These companies now tap private sources of capital, and all is well that ends well. But that may not be the case for those investors who are investing through their 401(k)s. Mr. and Mrs. 401(k) are the folks that I am thinking about.

Think about the lost opportunities for everyday Americans to create wealth if the next Boeing, Walmart, or Allstate do not go public, or go public later in their life cycles than they would have decades ago. The more expensive or burdensome the Government makes it for a company to go public, the less we will see folks take the risk. That has a negative impact on individual investors, retirees, and those saving for a rainy day.

Mr. Keating, how has the dramatic drop in companies going public hurt Mr. and Mrs. 401(k)?

Mr. KEATING. Well, I think you summarized it well in terms of not having access to being able to invest in a whole host of companies, especially earlier on in the process. And I think when you look at—there are a whole host of things going on in the economy that contribute to this, you know, a recession, a poor recovery. We have grave concerns about the level of entrepreneurship in this country and why it is off.

Senator SCOTT. Yes.

Mr. KEATING. So these are all factors in the equation. But I think also the regulatory costs, the signals, what it takes to go public today is very different from not that long ago, and I think those costs are real and significant. You know, again, there are studies that will back that up, and I think Economics 101 kind of backs it up.

Senator SCOTT. How will the HALOS Act and other bills we are debating today reverse that trend?

Mr. KEATING. Well, I think when you go down the list, these are moves in a positive direction. In terms of—you know, the problems with regulation are multiple. You know, these efforts are trying to clarify regulations. They are trying to get more resources toward innovation and investment rather than unnecessary regulatory compliance, trying to streamline the process, for example, in terms of IPOs, reduce unnecessary costs, et cetera. So these are the types of move, while still obviously protecting investors and consumers and so on, that are needed to kind of bring some regulatory balance back into the equation.

Senator SCOTT. Thank you. One last set of questions for you, Mr. Keating. In tax reform, it included my signature legislation, the Investing in Opportunity Act, the IIOA, that has created the opportunity zones around the country that so many folks were pretty excited about.

The good news is that this legislation was championed on both sides of the aisle. So often we hear folks in Washington and other countries talk about the fact that there is no bipartisanship. I cannot say they are not always wrong. However, the IIOA is truly a bipartisan effort where folks on both sides of the aisle see the wisdom of bringing private sector capital back into the distressed communities where more than 50 million Americans live.

My question to you is: Can you expand on how the capital gains tax deferral, which is the real motivating factor for folks to take a second look at those opportunity zone areas, how that deferral for investments made in opportunity zones will jump-start capital formation where it is needed the most?

Mr. KEATING. When you talk capital gains tax, you are talking my language. And, also, opportunity zones are—you know, I am an old disciple of Jack Kemp and Ronald Reagan, OK?

Senator SCOTT. Yes.

Mr. KEATING. So I love the idea that the message here is reduce these burdens, reduce these costs, and let the private sector flourish. And when you are talking about capital gains, what is a capital gains tax? It is a tax on the return on entrepreneurship and investment. The more you tax it, the less of it you get. Economics 101. So these types of efforts like you are talking about with opportunity zones, other things that we are advocating—we regret that the overall tax reform bill did not reduce the capital gains tax rate. We are a big advocate of that. So these types of measures I think are crucial just to incentivize. I am economist. It is a bad incentive, and you want incentives for entrepreneurship and investment to flourish in these areas where it has not before.

Senator SCOTT. I just wish we had more time. Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Heitkamp.

Senator HEITKAMP. Mr. Keating, just not to belabor the point, there are two different perspectives on taxation of capital gains.

Mr. KEATING. Well, there are many perspectives.

Senator HEITKAMP. Well, I think it is difficult for someone like me to explain to a worker at Bobcat who puts on a shirt every day and gets dirty that he pays more than people living on trust funds. So I think it is important that we kind of talk about who is that person who has made these investments and what is their long-term contribution. I think we all want to give contributions to people who are actually increasing the productivity of this country.

Unfortunately, in many cases capital gains—the people who are wealthy enough to have capital gains are the people who where the money makes the money and not the productivity. You know, we can get into long economic——

Mr. KEATING. I would like to have a chat——

Senator HEITKAMP. ——argument——

Mr. KEATING. ——sit down in your office and have a good chat.

Senator HEITKAMP. I do not want to take up my time. I would love to have that debate because I think that I do not disagree with the conversation you just had with Senator Scott, that there has got to be some way to incentivize investment and entrepreneurship.

Mr. KEATING. To get the productivity you are talking about.

Senator HEITKAMP. I might argue that one of the reasons why you see a decline is the increasing interest rates and burden put on young entrepreneurs by the challenges that they have, which includes student debt.

I want to know in your numbers, when you are looking at investment, which is fascinating because I think it tells a story that is not well understood in the American public, do we have a differential—have you broken it out by rural communities or rural counties versus urban counties?

Mr. KEATING. I have not, but others have, and I can get you that information.

Senator HEITKAMP. That would be great.

Mr. KEATING. The rural, that is where we are suffering in terms of entrepreneurship and investment, without a doubt, and certain inner-city communities. But those are the areas that are being hit hardest that are still kind of, if you will, stuck in the recession.

Senator HEITKAMP. What I always tell people is—I do something that a lot of people here do not do, which is represent rural America, and I know Senator Rounds and I have joined on a lot of this, but rural America is—if you want to at rural poverty, if you want to look at stagnation in growth, we can talk about why that is happening. But, obviously, investment in rural America was a bit motivator for S. 2155. We think that that may bring some investment back, but I think we need to jump-start that investment. And so I am interested in your perspectives, and maybe you can come in and just talk with me. We will have a debate.

Mr. KEATING. I would agree with that, and also things like broadband in rural communities, these are all vital things that we——

Senator HEITKAMP. Right. We are going to debate a farm bill that has rural economic development.

I want to turn to money market reforms in S. 1117. Mr. Daniel, I was taken by your analysis of what the SEC rules have cost State and local entities that live off investment income, and, you know, obviously the SEC has disagreed. That has long been the debate here. And I am wondering, when the SEC adopted the floating NAV rule in 2014, their analysis suggested that the impact on the market would be minimal. They just did not see that that would have a big impact. And I think you are arguing the market has moved since implementation of this rule and left some people behind that they did not think would be left behind, right?

Mr. DANIEL. Senator Heitkamp, that is correct. At the city of Albuquerque, like many of our medium- and small-size peers, we provide a plethora of services. We provide airport services, refuse, transit, cultural services, family and community services, and a host of other things, and some of our peers provide even more than that. We as finance officers consider ourselves enablers of those types of services.

With capital being limited, it is vital for us to be able to gain as much safe investment income and to be able to finance through short-term debt offerings at as low a rate as possible to help finance these services. What has happened is that the decreased income from us having to shift into Government funds for investments by 25 basis points or more and the increased cost of us having to move to fixed-rate debt has squeezed our ability to fund these types of services.

Senator HEITKAMP. Are there other factors in this shift when you analyze what that—when you look at it, obviously, there is a concern that we have in this Committee or we would not be hearing this bill, to analyze this. But have you seen other factors that may have driven that shift like tax reform, like——

Mr. DANIEL. Senator Heitkamp, from my perspective the cause is primarily from the floating NAV rule. The 2010 amendments to Rule 2a-7, as stated previously, provided higher quality, lower maturity, and the ability to stabilize money market funds. From 2008 until 2016, when these amendments went into effect, the industry was very stable. The prime funds which we were investing in, we consider a very safe vehicle for public funds investment. And so with us not having access to those, it has really squeezed our ability to provide public services and infrastructure.

Senator HEITKAMP. Obviously, we want to be good partners with State and local government, want to better understand this issue, and so thank you so much for your testimony, thank you all for appearing on these bills.

And thank you, Mr. Chairman and Ranking Member, for holding this hearing.

Senator BROWN [presiding]. Senator Kennedy.

Senator KENNEDY. Thank you, Mr. Chairman. I want to thank Senator Rounds and Senator Toomey for letting me jump the line here. I have got to go preside.

Professor Bullard, I listened to your testimony very carefully and was very impressed. Let me ask you sort of a 30,000-foot question. Do you think most Americans who work in the financial services industry cheat their customers?

Mr. BULLARD. No, I do not think so.

Senator KENNEDY. But some do?

Mr. BULLARD. Absolutely.

Senator KENNEDY. So our job is to try to draft legislation to catch the cheaters and prohibit them from cheating while at the same time not undermining the work that the honest people do in financial services which is vital to our free enterprise system. Is that about it?

Mr. BULLARD. I agree.

Senator KENNEDY. OK. Mr. Keating, let me ask you a quick question about SBICs and rural investment companies. You know what an SBIC is, obviously.

Mr. KEATING. Yes.

Senator KENNEDY. It provides capital to small businesses, often in suburban and rural areas, regulated by SBA. We also have an investment vehicle called "rural business investment companies," do we not?

Mr. KEATING. Yes.

Senator KENNEDY. Regulated by USDA.

Mr. KEATING. I believe so, yes.

Senator KENNEDY. Dodd–Frank Act regulated both SBICs and RBICs. Is that right?

Mr. KEATING. Yeah.

Senator KENNEDY. In 2015, Senator Kirk and Senator Manchin, with President Obama's support, passed a law by the name of—well, I do not have it here now, but it is—here it is—no, it is not. Its purpose was to give some relief to the SBIC advisers, right?

Mr. KEATING. Yes.

Senator KENNEDY. But they did not include RBICs. Why was that?

Mr. KEATING. I do not know because it would seem like it would be a natural coupling.

Senator KENNEDY. Well, Senator Jones and I have a bill. It is called the "Rural Business Investment Company Advisers Relief Act of 2018", and basically it would say that we are going to treat advisers to SBICs, which were given some relief by President Obama in 2015, the same as the financial advisers to these RBICs because both advisers are kind of small-time. What do you think about that bill?

Mr. KEATING. This is one of the bills that we support here. The SBE Council has stated its support, and it makes perfect sense in terms of providing basic relief from unnecessary costs and burdens that these regulations should not apply to these small folks.

Senator KENNEDY. And I want to thank Senator Jones for all his hard work on this bill. If our bill passes, it is not going to do anything to preclude or prohibit the requirement of registration by most advisers to private equity funds, is it?

Mr. KEATING. As far as I know, no.

Senator KENNEDY. OK. We are just carving a little bitty small niche for advisers to these rural investment funds, and we are treating them the same way that President Obama and Senator Manchin and Senator Kirk and the entire U.S. Congress treated the advisers to the SBICs in 2015. Is that right?

Mr. KEATING. Correct.

Senator KENNEDY. OK. Have you got any other thoughts about this wonderful piece of legislation?

[Laughter.]

Mr. KEATING. Well, I would echo that it is a wonderful piece of legislation. It goes along with what our emphasis at SBE Council is; let us make regulation rational across the board, and let us not place excessive undue burdens on small businesses, including rural investment advisers.

Senator KENNEDY. And I agree with you, but it is also about equal treatment, is it not?

Mr. KEATING. Yeah, well, I mean, that is——

Senator KENNEDY. If you and I are in similarly situated circumstances, the law ought to treat us the same.

Mr. KEATING. You are absolutely right, and that is one of those unfortunate things when you get into regulation and politics, that you and I might sit here and say, well, why was the rural community left out here, and, you know, that is one of those things that we economists would go back to public choice theory and say, well, who was lobbying and who was doing this and who was doing that, unfortunately. So I think equal treatment across the board where it makes sense here is perfectly logical.

Senator KENNEDY. OK. I found the name of the bill. It is called the "SBIC Advisers Relief Act". My staff had it right here all the time.

Thank you, Mr. Chairman.

Senator BROWN. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

As a former mayor, one of my primary concerns on this Committee has been ensuring access to capital for New Jersey's towns and cities, particularly to ensure that there are liquid capital markets to help finance infrastructure and economic development projects all across the State. And when communities in New Jersey thrive, the Nation thrives. New Jersey and other States in the Northeast corridor contribute nearly $4 trillion, or 20 percent of the entire Nation's GDP. Over the last several years, I have heard from officials all across New Jersey with concerns about their access to capital, funding that they depend on to get the lowest-cost financing for public infrastructure projects, affordable housing properties, schools, hospitals.

Money market funds are important to municipal governments for two primary reasons: one, they serve as a major source of investment in municipal debt, helping to finance key projects; and, second, local governments utilize money market funds themselves as both an investment and cash management option because of their safety and simplicity.

The SEC's new rules requiring certain money market funds to change the way in which they report their net asset value has led to both a decreased demand for municipal debt by certain funds and in turn higher borrowing costs, as well as serving to limit the utility of a key investment vehicle for State and local governments. And in response to the concerns that I have heard from New Jersey's Association of County Administrators, the mayors, for example, of my State's two biggest cities, Newark and Jersey City, among others, I cosponsored Senator Toomey's legislation. Our legislation would both preserve money market funds as a source of liquidity and capital to meet the public infrastructure and investment needs of New Jersey's communities, and it will preserve money market funds as an important cash management tool for State and local officials. So that is the focus in which I come to this particular legislation with.

So let me ask, Mr. Daniel, can you walk us through how the SEC's new rule has increased municipal borrowing costs and how those increased costs affect local government public infrastructure, housing, education, health projects, for example?

Mr. DANIEL. Senator Menendez, I would be happy to. The new rule has shifted investment in money market funds to Government funds and away from prime- and tax-exempt funds. This decreased demand for tax-exempt floating rate debt has forced Governments to either increase rates on these debt offerings, which still may not attract demand due to the floating NAV, or try to access higher-cost alternative financing. In either case, cost to taxpayers and ratepayers increases because expenditures in infrastructure, housing, education, and health projects may suffer diminishment.

Senator MENENDEZ. Let me ask you this: Do those increased borrowing costs remain even when controlling for the current interest rate environment?

Mr. DANIEL. Senator Menendez, yes, increases in the Fed funds rate and other money market rates necessarily rise concurrently, although not in tandem. Nonetheless, capital will still flow from floating NAV instruments, causing Government borrowers like ourselves to raise our issuance yields and borrowing costs or seek out other higher-cost financing.

Senator MENENDEZ. For those municipal borrowers who can no longer rely on money market funds as a stable source of capital, where are they going to fund their projects?

Mr. DANIEL. Senator Menendez, we will be forced either to issue higher fixed-cost bonds, which creates an asset/liability imbalance, or access bank capital. The problem with that is that we are often crowded out of low-cost bank financing. So it is vital that this floating NAV rule be reversed so that we can invest our funds at higher rates and have access to the tax-exempt floating rate debt market.

Senator MENENDEZ. From a New Jersey perspective, according to one estimate, we have lost $2.7 billion in financing from certain money market funds. Financing infrastructure projects in New Jersey is a top priority, and this is one of our challenges.

Do you think that investors who have left the municipal money market funds would come back to the funds if those funds were able to again report a fixed net asset value?

Mr. DANIEL. Senator Menendez, absolutely. Over $1.2 trillion float out of prime- and tax-exempt funds to Government funds, beginning with the announcement of the 2014 amendments to Rule 2a-7, even before it went into effect in October 2016. And most of that money has not come back.

As an investment officer for a medium-size public entity, I feel absolutely that investment will come back to prime funds because we consider them a safe vehicle for investment and tax-exempt funds because we would consider ourselves investors in public infrastructure and public services.

Senator MENENDEZ. All right. Thank you very much.

Senator BROWN. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman—well, Mr. Ranking Member. I am glad we are having this hearing today. This is an important opportunity to continue the work this Committee has been doing, and I want to specifically encourage support for two bills that I have introduced with colleagues here. One is the HALOS Act, which is S. 588, and the other is the Consumer Financial Choice and Capital Markets Protection Act, which we have been discussing.

Very briefly, on the HALOS Act, I would just stress this is a bipartisan bill. Senators Murphy, Thune, Schatz, and Heitkamp as well as myself are cosponsor of this bill. It is a narrow fix related to the demo days and their treatment under the JOBS Act. Demo days, as I think we all understand, these are events that are sponsored often by universities or economic development officials, often to which angel investors are invited. Entrepreneurs make a broad pitch about an idea or a company, and these demo days existed for decades prior to the passage of the JOBS Act, and they were never considered general solicitations. It was only after the JOBS Act that the SEC decided to treat demo days as general solicitations. So this is a very narrowly tailored bill. It makes it clear that demo days should not be considered general solicitations. It would not allow nonaccredited investors to invest in nonpublic offerings, but what I think it would do is help entrepreneurs access capital and help promising businesses to grow.

I want to spend most of my time on the Consumer Financial Choice and Capital Markets Protection Act. This is another bipartisan bill. As Senator Menendez pointed out, he and I have introduced this legislation together with Senators Peters and Rounds, and as we have discussed, it deals with the regulatory treatment of money market funds.

We have heard once again what I think we all know to be true: Money market funds have been a critical source of short-term financing for businesses, for States, for municipalities. It is attractive to issuers. But it is also attractive as a place to manage surplus cash for municipalities and others.

You know, the 2008 financial crisis obviously put enormous stress on our financial system. Hundreds of banks failed. Money market funds experienced some stress, yet only one broke the buck, and even then investors received 99 cents on every dollar. And despite that, in 2010 the SEC implemented major new regulations meant to enhance the safety and security of money market funds. There were stringent liquidity requirements, shorter maturity requirements, and then 2014 came along, and with no evidence that the 2010 reforms were somehow inadequate—there had been no problems in the interim—nevertheless, there was yet another wave of new regulations imposed on these instruments that had exhibited no problems whatsoever—more stress testing, diversification requirements, additional disclosures, and most problematic, as we have discussed, one category of money market funds, the institutional prime- and tax-exempt funds, were required for the first time to have what we call a "floating net asset value" to abandon the practice of over 40 years and that all other money market funds continue, which is to have a stable net asset value.

As we have discussed, exactly as some of us predicted, well over $1 trillion promptly left the prime- and tax-exempt money market funds. The funds largely shifted to Government and agency funds. And the result of that, as Mr. Daniel has very persuasively argued, is higher cost of funds for municipalities and corporate borrowers, lower return on surplus cash that municipalities invest, and no persuasive evidence at all that anything has been accomplished by way of safety and soundness.

So what our bill does is it simply allows all money market funds to elect to operate with a stable net asset value, as most can today. It would not be required, but that option would be available. And it waives the mandatory liquidity fee. This is essentially a withholding on withdrawn money that went into effect in 2014. All the other myriad and very extensive regulations imposed in 2010 and in 2014 would remain in place. They would still be very, very heavily regulated, but there would be this important change that would allow these funds to go back to the way things had been for 40 years.

Mr. Daniel, here is my question for you. We have discussed various aspects of this. Could you just explain to us why having a stable net asset value is so important and why that is so much preferred by investors such as yourself and your colleagues over the floating net asset value?

Mr. DANIEL. Senator Toomey, our statutes and investment policies as public investment officers prohibit us from investing in floating NAV vehicles. They also prohibit us from investing in a vehicle that would have a liquidity fee associated with it. Therefore, we are being forced into these Government funds as investments.

Would you repeat the last part of your question, please?

Senator TOOMEY. That was the main gist of it. I wanted to understand why you find a stable NAV more appealing, and I think your answer is you just do not have any choice in the matter, right? You are restricted and required to invest in something that does not have a liquidity fee and something that has a stable net asset value.

Mr. DANIEL. Senator Toomey, that is correct. And, of course, we are more inclined to invest in prime funds rather than Government funds because of the higher yield, and we consider those prime funds to be very safe vehicles for investment.

Senator TOOMEY. Thanks very much. I see my time has expired, Mr. Chairman. I would just remind my colleagues we have seen what has happened as a result of this misguided policy. Over $1 trillion have left the nongovernment money funds. Borrowing costs are higher. Returns on surplus cash are lower. The time has come to pass this legislation.

Thanks, Mr. Chairman.

Chairman CRAPO [presiding]. Thank you.

Senator Jones.

Senator JONES. Thank you, Mr. Chairman, and thank you to the witnesses for your attendance here today.

I want to kind of go back to a bill that Senator Kennedy talked about. Briefly, it is one that Senator Cotton and I have introduced concerning the small business—you know, it is the Small Business Audit Correction Act, and I think it is pretty clear that everyone on both sides of the aisle in Congress always take investor protection very seriously, and we should never take it lightly. But I also recognize that sometimes rules can kind of spread and have meanings that catch up small businesses when they were not intended. I think our bill is a perfect example of trying to give some relief to small businesses, small firms which are privately held, noncustodial broker-dealers who do not handle client funds, and that are in good standing, and going to exempt those firms from the rigorous PCOAB audits.

So, first, I would like to ask you, Mr. Keating, it sometimes can seem like a small issue, but can you just give us a sense of what regulatory costs like that can mean for a small firm, especially, you know, a noncustodial type business?

Mr. KEATING. Well, I think in general, you are right, it can seem small, but when you look at this type of requirement and you look at other regulations, this is one of the things that we have to fight on a constant basis, because it is not just the additional costs of this regulation, but it is on top of everything else along the way.

So when you look at small firms, again, they do not have, you know, the legal department down the hall to handle these types of things. You are right, they often serve as a surprise because that legal department is not down the hall. So there are a whole host of things here. It is uncertainty, it is costs, and ultimately it is what would you be doing with those resources otherwise.

Senator JONES. Right, and it is important to note, again, that these are noncustodial. They do not handle client money, so they are not auditing any kind of money coming through like that.

Mr. KEATING. What is nice about all these bills that we are talking about that we support today is they are commonsense carveouts. That is why I think they are bipartisan, which is, again, a wonderful thing. Somebody mentioned before we do not see too much bipartisanship, but they are commonsense carveouts that small businesses certainly would——

Senator JONES. All right. Mr. Bullard, I would like to follow that up with you, though, and especially in light of earlier comments to Ranking Member Brown about the need for audits, and sometimes the problems that we see when we exempt and carve out industries and companies from having those. I recognize that. As a lawyer, I have seen that all too many times.

I also know that the Accounting Institute, American Institute of CPAs, has kind of consistently said that this might not be needed for these firms, but I would like to get your thoughts on this particular bill if you are familiar with it and what you think about it.

Mr. BULLARD. This is the exemption for broker without custody?

Senator JONES. Yes.

Mr. BULLARD. I think that there may be other reasons—there are a lot of reasons why an entity might be subject to public accountant oversight. But if they do not have custody, that resolves the securities law issue. And I agree that unless there is some other public policy concern, there is no reason to require that they have a public accountant.

Senator JONES. All right. Great. Well, thank you for that, and I appreciate Senator Cotton's work with me on that. And so let us go back to the one that Senator Kennedy talked about a little bit, Mr. Keating, you know, the bill on the RBIC Advisers Relief Act. Can you just kind of comment a little bit more broadly on the policy challenges for rural businesses looking for their capital to grow?

Mr. KEATING. Well, I cannot—yes and no. I mean, in terms of rural businesses in general, when you are talking about access to capital, which is what this is ultimately for, there are just far fewer options. When you look at—you know, we talked about banks briefly—the dropoff, dramatic, in the number of community banks, that has hit rural America very, very hard. And it is not just the dropoff in the number of existing banks, but there are very few banks coming in; new banks are not being developed.

So all of these things come into play, and I think the rural community is just limited in terms of the realities of rural America, so why would we want to, you know, treat this particular issue differently in the rural community and leave those additional costs and burdens when we have dealt with it on other fronts?

Senator JONES. Right. That is great. Well, thank you both for those answers. And, Mr. Chairman, I appreciate everyone being here. Thank you.

Chairman CRAPO. Senator Rounds.

Senator ROUNDS. Thank you, Mr. Chairman. First of all, let me say thank you to you for holding this meeting today. I think it is very important as we have a number of different ideas being discussed, that we have a public discussion like this and really vet it.

I think there is an agreement among at least two of you, Mr. Keating and Mr. Daniel, as to the acceptability of the Consumer Financial Choice and Capital Markets Protection Act that Senator Toomey is sponsoring and I am a cosponsor of.

Mr. Bullard, in reading your testimony, you identified first that when the original changes to this which was made back in—right after the recession, you had indicated that you thought that it was a mistake to have made the changes and the further regulations which restricted or made it more difficult for municipals to actually be able to access the money markets. But then you went through an analysis of the concerns that you had right now, and I think in all fairness, we have not really heard about those. I think this is a move in the right direction.

But you had some suggestions out there about concerns that you felt were appropriate to lay out. Can you talk a little bit about these limitations or restrictions that you fear the bank regulators would put on that we should be aware of or that might very well be areas that should be addressed as well in other legislation? Then I am going to ask our other two members here their thoughts about other items that should also be addressed besides the bills that are here in front of us today, other ideas that you have that you are wondering either why we have not done it or that we should modify within the existing bills. Mr. Bullard, would you like to just talk about that for a minute.

Mr. BULLARD. Sure. That is correct that I testified against the SEC rules primarily because money market funds had demonstrated an astonishing level of safety, especially having had two break a dollar, one not even a retail fund, over about 40 years, at the same time thousands of banks failed. But I think one of the concerns Vanguard and BlackRock have and one reason they are probably opposing this is, of course, that these rules were adopted in response to the Dodd–Frank Act, which gave banking regulators, in my view, far too much authority over what I would call risk-based markets. Banking regulation and banks are designed with the socialization of risk in mind, and when you put them in charge and the SEC realizes that FSOC is controlled by banking regulators, they will bend to banking regulators' will. So I cannot even fully blame them for what happened. But it was, I think, inevitable that there would be massive dislocation and expense. That has already occurred. Since then I think that there have been mitigating effects on the municipal business, but I think that is probably a close call. But I am concerned about that BlackRock–Vanguard concern, which is if you reintroduce floating rate NAV funds, frankly Federated will roll out a lot of funds. That will be a competitive disadvantage for the large money market fund managers. They will have to go back into the business, and then the next time a money market fund breaks, the banking regulators will have a lot less power to save the industry and, frankly, I would expect Congress to go back and end up maybe taking the same steps that dislocates the industry again.

I think the interesting point of view is we have been through this once. We do not want to go through it again. Just leave us alone.

But, you know, the free market guy in me says there is more capital that is out there looking for purchasers in a demonstrated, successful way to create essentially a cash vehicle for retail investors, and that should be an available option.

Another concern is really a specific SEC concern. One reason the Reserve Fund failed is the SEC was not monitoring the funds that had the greatest risk of failing. It also had this no-action process whereby a fund that was about to break a dollar, which had happened hundreds of times previously, was to call up an office in the SEC, and a guy picks up the phone and says, "OK, you are fine," and because that process was fumbled by the staff, in my opinion, and because it was such an ad hoc system in the first place, that contributed to the Reserve Fund failure. It was a primary element of their defense when the founders were sued, and I think that has to be corrected.

And then, finally, I think that it is a mistake—as much as you can tell, I am probably not the biggest friend of banking regulators—to overly hamstring their Depression era authority to emergency situations, use their lending authority for nonbanks. I think that this bill would further hamstring them, and I think that is a mistake.

Senator ROUNDS. Thank you. And I am out of time, Mr. Chairman. I would just ask for the record if I could ask each of our other two gentlemen to respond. You have heard the discussion here on the part of Mr. Bullard, but I most certainly think it would be fair to ask you to respond to that and to point out your differing points of view to the argument that he has made.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you. And as I will explain to the witnesses at the end of the hearing, there will be follow-on questions, and we ask you to respond to those, and you are welcome at that time to respond to this one and others.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. And thank you for holding this hearing.

I want to talk a little bit about the HALOS Act that I know that a number of my colleagues have cosponsored. I am taken by some of Mr. Bullard's comments. As a former venture capitalist, I have thought of a lot of events that right now that have been prohibited that I did not feel at all fell into kind of the normal solicitation category. I even think about the fact that I think the effect of some of the regulations now—sitting on the Intelligence Committee, I look at the enormous threats we face in the cyberdomain and we are technically even holding hack-a-thons now where we try to explore different, better techniques on providing cybersolutions that could fall astray.

And so what I am wondering—and this is directed to you, Mr. Bullard, and you, Mr. Keating, if you would like—is that there have been a couple of amendments added in the House, because I am not looking at something here to try to give an unfair advantage to one set of investors over retail investors. But there were two amendments added, one that would have required that attendees of demo days receive an SEC-prescribed risk disclosure that clarified that simply attending a demo day would not put them into that—would not mean that they passed the preexisting relationship test, that would still stand in terms of their ability to look at any of the companies or ideas that were put up; the other would have prohibited those who sponsor these so-called demo days from compensating companies and investors that were participating and making sure that none of the companies that were participating—making sure that all the companies that were participating were operating companies, that none of them were bankruptcy. Knowing your reluctance in this area, did that move it in the right direction? Are there other things that could be done? And I would like to hear from you as well on this, Mr. Keating.

Mr. BULLARD. As I noted earlier, if we are going to move in that direction—and I think the JOBS Act already put us well down that path; the HALOS Act frankly simply extends that further—then we need to rethink what is the substitute for that central regulation of offerings that was really the basis of the Securities Act. And the obvious substitute would be something like you describe, which is if you are going to go out publicly and talk about raising capital, you need to make basic information available. And the first step would be what you describe, which is: Is this really an operating company? Does it have some kind of financial statement? And to make that, speaking partly as a researcher, publicly available in what I would hope would be a very efficient, cheap filing system so that we could get that data, and I——

Senator WARNER. So it is not giving the attendee some advantage over other potential investors.

Mr. BULLARD. That is also part of the reason. The big informational disadvantage is, I think, more in the public market where you have got months-long road shows going on with institutional investors and mutual funds, and then 2 weeks before an offering, the retail investors get their first look at an IPO registration statement, and the SEC continues to let them make material amendments. I think they would let them do it up to the day before the offering. And we saw what happened with the Facebook fiasco, and I think that, you know, we need to think about how we are going to resolve that issue. But, again, that is assuming that we have moved to a different model, which I think we have done, but we continued to impose an irrational way of describing the model, which is clarifying general solicitation as opposed to recognizing that general solicitation is what we have allowed, and to think about what the substitute would be.

Senator WARNER. Mr. Keating.

Mr. KEATING. I would have to take a closer look at those amendments, but in general, I would not have a problem with them. What we are talking about here is going to angel investors. I mean, that is in the title of the legislation. So I think when we are talking about understanding who we are going to and what the purpose of these demos are, I think it makes—-I think the legislation makes perfect sense.

Senator WARNER. And as somebody who has been very active in trying to set up angel investor networks, particularly in rural and more disadvantaged communities, I think there is an enormous value there. I do think we need to consider some of Mr. Bullard's concerns. I would point you to both of those amendments in the House that were included, and I would also make the point that I think no one would want to restrict, for example, the ability to have hack-a-thons that are advancing that may have as a secondary value some opportunity into investment.

I have got 20 seconds left, and I just want to make this on a pitch basis. You know, Senator Heitkamp raised about capital gains. I would argue that some of the greatest abuses in our Tax Code are people converting ordinary income into capital gains on a short-term basis and that one of the greatest challenges that modern American capitalism faces right now is this enormous focus on short-term over long-term value creation. And I would hope, Mr. Chairman, we could come back at some point and hold a hearing that would examine a differential capital gains rate for longer-term holds that would look at different countries, their long-term stock exchanges, even look at additional voting power based upon holding shares, different reporting standards. I think this quest for short-term quarterly based profits will ultimately destroy the kind of great American business paradigm that was created post– World War II. As a matter of fact, I would argue that we would not be able to create the same kind of economic growth engine in today's market, and the examples of tech companies that still are able to do that are because there is a different class of stock for the founders that allow them not to have the pressures put on that are put on other corporate enterprises.

Thank you for letting me go a little extra. Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Warner. And I am aware of your work on the short-termism issues. I think it is a critical issue that we do need to pay more attention to.

Senator Cotton.

Senator COTTON. Thank you, Mr. Chairman. Thank you, gentlemen, for your appearance today.

I would like to say a few words about the topic Senator Jones addressed, the bill that we have introduced, the Small Business Audit Correction Act. The bill would correct one of the unintended consequences of Dodd–Frank, specifically the massive increase in audit costs for small noncustodial broker-dealers. This is a big problem.

In hindsight, I think it is clear that Congress overshot the mark trying to prevent another Bernie Madoff-style scandal when it extended the Public Company Accounting Oversight Board audit requirements to these small noncustodial broker-dealers. As a result, public company audit rules for gigantic firms now apply to firms that do not hold customer assets and could not even pull off a Madoff scam if they wanted to in the first place.

Now, this requirement might seem harmless or obscure, but, in fact, it has increased costs for small broker-dealers a lot. One Arkansas broker told me that his audit costs have gone from $6,000 to $30,000, and he has only five employees, and his offices are much smaller than the room in which we now sit.

That is not an isolated incident to Arkansas either. I would venture that every Member of the Banking Committee has constituents just like mine. And when you think about it, this is a classic square peg into a round hole problem. As one Board-registered audit firm wrote in a letter, "The Board audit requirement makes sense for public companies like Apple and broker-dealers that carry customer funds or securities like Morgan Stanley because the investing public and markets are potentially at much greater risk from these companies. Conversely, the Board requirements make no sense for privately held, small noncustodial firms that do not carry customer funds or securities, companies like mine. Currently a three-person small business is held to the same standards are Merrill Lynch. This is not right, fair, or reasonable."

As he wrote, "In other words, it is the big guys, the custodial firms that should be receiving the Public Company Accounting Board audit, not these little guys."

Both the SEC and the Board have said that they have no data to suggest that this requirement has created a healthier or safer investment environment. In fact, even Board-registered audit firms whom you would think would be in favor of this requirement are speaking out against it. But it should not be a surprise they are losing business as small brokers die out.

That is why my legislation with Senator Jones would make a simple change. It would exempt the small privately held, noncustodial firms in good standing from this Board requirement and allow them to file their financial statements according to GAAS standards they used just a few years ago.

It is true regulators like the SEC and FINRA could relieve some of this compliance burden themselves, but they could also reverse that decision later on. I think our small broker-dealers deserve the regulatory certainty that will only come from a change in the law.

I think this is simply common sense, and I know it has widespread support. We have heard from many organizations who have sent letters of support, and as far as I know, there are no organized groups opposed.

So, to sum up, I believe these unnecessary regulations are crushing our small broker-dealers and holding back economic growth, particularly in States like Arkansas. If we pass our bill, we can help lighten the load a little bit and allow more Americans to invest their money with small local broker-dealers if that is their choice.

I address the question first to you, Mr. Keating. Do you feel that these small noncustodial firms, perhaps more importantly their customers, would benefit from returning to this kind of rightsized audit standard?

Mr. KEATING. Yeah, I would agree with you 100 percent. I think you laid it out very well, and I think this legislation makes sense, and I think any kind of scaling to fit the size of the business has to be thought about when we are moving ahead with legislation and when folks like the SEC are moving ahead with what they are—you know, in terms of the regulatory burdens they put on things. And that speaks of just a larger regulatory issue of can we—you know, we need some institutional reforms in addition to fixes like this so we do not have to come back and keep doing this, you know, cost–benefit analysis. There is a bill in the House, 78, where the SEC would be required to do cost–benefit analysis and look at the impact on small businesses and market liquidity and so on.

So I think this makes perfect sense, and I think we need tot make the next step and say how do we stop the overshooting that you talk about.

Senator COTTON. And, Professor Bullard, do you share that opinion?

Mr. BULLARD. I share the opinion on the bill, yes.

Senator COTTON. Thank you. My time has nearly expired. I do hope this Committee can mark up our legislation and then move it to the floor for a vote, as well as some of the other meritorious bills we have passed. As our witnesses have made clear today, too, I think this is another good example of working together in a bipartisan fashion. I know we do not have unanimous support for this legislation, but that is pretty rare around here. But we do have healthy support from both Democrats and Republicans, and I want to thank the Chairman and the Ranking Member for trying to move ahead with additional and important legislation in this Congress.

Chairman CRAPO. Thank you.

Senator Schatz.

Senator SCHATZ. Thank you, Mr. Chairman. Thank you for having this bipartisan hearing. I want to thank you for the way you conduct all of your hearings. You are a model for the regular order, and we really appreciate it. I will just add gently that we look forward to our hearing on credit bureaus and credit reporting agencies. Senator Kennedy and a number of Senators on both sides of this dais are anxious to dig into this issue, so we have several more months of legislative work to do, including during August. That would be an appropriate time to consider those issues.

Mr. Keating, you know that startups have created around 20 percent of total job creation every year, and these demo days are really a critical aspect of it. There is some confusion in terms of how to maintain compliance, especially as you get further and further from centers where venture capital exists.

Can you talk about the role of demo days for startups in terms of surviving their earliest moments?

Mr. KEATING. Well, yes, in the sense that specifically I can talk about the importance of angel investment. You know, when you look at the stages of a startup, you are going to your own savings first. Then you go to family and friends, and the natural next step are angel investors. Who are angel investors? Well, there are networks of them, of course, that have developed especially recently, which are wonderful, but they are usually, you know, professional people that are looking for investment opportunities. Perhaps they have started up their own businesses and are looking to help others as an investor–mentor scenario. This is not unusual in the angel community. And when you look at the numbers, they are a vital source, you know, because there are a whole host of companies that cannot go to banks. I taught MBA students entrepreneurship and innovation for 10 years, and you can talk about what you take to the bank. But you know what? More often than not, you have to be a little more established to get that bank loan. So angel investors are critical there, and any kind of ability to reach out and simply communicate to them—and, again, with all the safeguards in place, and I think Senator Toomey laid it out pretty well, that, you know, it is not like we are reinventing something new here with this legislation; we are going back to the way it was before—makes perfect sense.

Senator SCHATZ. Can you just talk about the—it seems to me that part of the problem is this operational difficulty. If you are trying to set up a demo day or if you are trying to participate in a demo day, the SEC says that they will evaluate each one on a case-by-case basis, and that is difficult if you are a three-person startup because you have got to lawyer up and interact with the Securities and Exchange Commission when you are still sort of scaling your tech, figuring out your pitch, and all the rest of it.

So can you talk about the importance of going away from a case-by-case analysis and to a sort of statutory framework that allows everybody to comply and to have confidence in the system, but not to disadvantage especially rural or sort of nontech hubs?

Mr. KEATING. Well, maybe the others can put some meat on the bone, but you put it well in terms of when you are developing your business, the idea that you are going to go to a regulatory agency and it is going to be a case-by-case basis, you know, really? So the idea that you have a statutory set way of doing this obviously is preferable.

Senator SCHATZ. Professor Bullard.

Mr. BULLARD. I would like to correct one thing. This is not a traditional practice by any means whatsoever. You are not permitted, except under the already approved general solicitation private offering rule, to go do these offers of securities, to do a pitch, giving terms and price and number. And you are not allowed to publicly advertise it. I mean, let us be honest. That is a huge change in the law. But the JOBS Act went a long way down that road.

Also, I hear references to HALOS, but there is nothing in the bill that prevents anyone from attending, and based on my experience at the University of Mississippi, they are attended by anyone who wants to. So there is no restriction to HALOS. This is not the HALOS Act. This is being able to have, you know, public demonstrations regarding both the operations of the business and its securities offerings.

Senator SCHATZ. Well, I will offer a thought, and then I will end with Mr. Daniel's comments. You know, it is not just the ability to track investment, but if you are—say the island of Maui, right, the majority of the population in the State of Hawaii is in Honolulu, but Maui has a thriving tech community. But part of the reason that they would want to do something like a demo day is not just to officially solicit investment, but also to find partnerships, to find new business opportunities that sort of are outside of the Securities and Exchange Commission purview, and also just to communicate to the broader public that there are some pretty exciting things happening on Maui. So part of it is just give a permission structure to economic development organizations, universities, you know, dual-use companies to kind of get into this without thinking to themselves, "I am going to get sideways with the SEC before I even have a going concern."

Mr. Daniel.

Mr. DANIEL. Senator Schatz, one of our critical missions at the city of Albuquerque is providing economic development for our community and our State without having to have taxpayers and ratepayers shoulder that additional economic development. That is why it is so key that we reverse the 2014 Rule 2a-7 reforms and return to a stable net asset value investment opportunity for prime- and tax-exempt money market funds.

Senator SCHATZ. Thank you.

Chairman CRAPO. Thank you.

Senator Tillis.

Senator TILLIS. Thank you, Mr. Chairman. Thank you for holding this hearing. And I think if you listen to the comments of colleagues on both sides of the aisle, you have done a good job of putting together for consideration measures that generally have support from both Republicans and Democrats.

I became a partner at Pricewaterhouse in 1996, and in 1996 we saw explosive growth because of Y2K. The world was going to end. You needed to prepare your systems and processes to deal with Y2K.

And then came Enron and Sarbanes–Oxley, and I saw explosive growth again. Because of the additional audit requirements, the Big Four firms that I was with at the time, all the other accountancies, just exploded. On the one hand, that sounds good if you are a partner. But on the other hand, you know that is an expense of using other service areas within Pricewaterhouse who really want to invest in projects to grow improved productivity. So you are moving—if you are in the health care or sciences field, you go from science to compliance, moving money away from building the future value of your company, and to just making sure you do not get penalties.

The banking reform act that the Chair did such a great job of getting through this Committee and getting to the President's desk I think provided much-needed relief for the lower base of what I call the "banking ecosystem," the community banks, the smaller regional banks.

I think what we are trying to talk about today are what I would consider to be modest proposals to take regulatory burdens off of some of the newer companies, the smaller entities. That is why I have sponsored the Encouraging Public Offerings Act and the Fostering Innovation Act that are being discussed today, having discussed today. And, Mr. Chair, without objection I would like to submit letters of support on the Fostering Innovation Act from organizations representing virtually everybody on this Committee.

Chairman CRAPO. Without objection.

Senator TILLIS. And we have bipartisan support for the bill.

This is, I think, a fairly straightforward bill which provides a very narrowly tailored exemption for SOX 404(b) for emerging growth companies that are now in their 6- to 10-year phase.

Mr. Keating, I do not know if you have had an opportunity to take a look at the bill, but do you have any concerns or comments you would like to make with respect to that bill?

Mr. KEATING. Just simply that I think there is a certain—you know, when you are talking about the limited aspect of this, it does not surprise—limited aspect but limited market that we are talking about here, it makes perfect sense. So I think the exemption makes sense. I think, again, you are talking about—what did you use, compliance rather than science? I am going to steal that if that is OK. I am sure it has been around.

Senator TILLIS. I stole it from my staff.

Mr. KEATING. But the idea that, you know, we want these resources for innovation and growth. We do not want them for unnecessary——

Senator TILLIS. Well, you see it in the biotech industry, and it is one that is growing nationwide. In North Carolina, we clearly have a critical mass there. It does not make sense to me. And I think that the way we have drafted the bill that it is tailored in a way that we are just simply removing a regulatory burden, but we have clear insights in what is going on with the companies, and hopefully we are going to get support from that. I do appreciate Members on both sides of the aisle.

On the Encouraging Public Offerings, that is actually two pieces. One is just codifying some of the administrative changes the SEC made last year, and then providing some other options for trying to—now I am going to the ecosystem. We do not have a very healthy flow of public offerings in the United States, and it is really counter to what we are seeing in most other, what we would consider to peer or near-peer economies.

Do you believe that there is something beyond just the regulatory hurdles that are doing that? Or are their economic underpinnings that would make some countries doing relatively better with IPOs than what we are seeing in the United States? Mr. Daniel.

Mr. DANIEL. Senator Tillis, I am not prepared to comment on that particular issue, but on behalf of GFOA, we will certainly get back to you with our response.

Senator TILLIS. That is OK. I just want to give everybody a chance to talk at least once.

[Laughter.]

Senator TILLIS. Mr. Bullard.

Mr. BULLARD. I guess I would take a different view that I articulated earlier, which is not only has there been steady and enormous growth in the amount of capital in our public markets, the proceeds raised in IPOs have zigzagged essentially the same way since the mid-1990s, before which gross proceeds were very low. And I also note that if you look at the growth of capital among U.S.-listed companies, we have grown substantially more and been far more resilient since the crisis than the best comparison, which would be European markets.

Senator TILLIS. So you think that it is structurally—the current state is structurally sound?

Mr. BULLARD. I do. I think we have vibrant markets that are still the envy of the world.

Senator TILLIS. I wonder why—or how does that square—and this is my final comment, but it may be Congress needs to be better educated. But if I am not mistaken, this bill got passed out of the House 60–0 in Committee and 419–0 in the House. So maybe we need to dig into that and understand why that looks like there is fairly broad—nothing gets passed out with a 0 on the other end of the vote. So it would be very interesting to maybe dig down on that, and we could possibly submit some questions for the record to get your insights on that.

Thank you, Mr. Chair.

Chairman CRAPO. Thank you, Senator Tillis.

That concludes the questioning here today, and the hearing will come to a conclusion. I want to again thank our witnesses for bringing us your expertise and being willing to share it with us. As the discussion here showed today, there is a lot of intense interest in these issues.

For Senators who wish to submit questions for the record, those questions are due on Tuesday, July 3, and I encourage the witnesses, if you receive questions, to please respond as promptly as you can.

Again, I thank you all very much for being here. This hearing is adjourned.

[Whereupon, at 11:34 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN MIKE CRAPO

Today's hearing will focus on several legislative proposals that will encourage capital formation and reduce burdens for smaller businesses and communities.

My goal is to work with Ranking Member Brown and other Senators on this Committee to identify and move legislative proposals that achieve these aims.

Many of the bills we will discuss in today's hearing have been considered in the House of Representatives earlier this Congress.

Of those that the House has considered to date, all have passed the House Financial Services Committee with bipartisan support and some have passed the full House, including one with a vote of 419 to 0.

Many of my colleagues on this Committee are also interested in these issues and have introduced Senate companions to many of these bills as well as taking the lead in introducing bipartisan bills in the Senate.

Senators Schatz, Toomey, Heitkamp, and Tillis, among others, have cosponsored a bill that would make it easier for start-up companies to tap the expertise and capital of angel investor groups.

Senators Toomey, Rounds, and Menendez, among others, introduced a bill that would provide more financing options for State and local governments seeking to raise money.

Senator Tillis has introduced a bipartisan bill that exempts emerging growth companies from certain auditor attestation requirements.

Senators Van Hollen and Tillis have cosponsored a bill that would encourage more public offerings by allowing all companies to "test the waters" prior to fling an IPO.

A bill introduced by Senators Kennedy and Jones would make it easier for investment advisers to focus on rural business investment companies.

Finally, Senators Cotton and Jones recently introduced a bill that will cut audit costs for noncustodial brokers.

These bills will improve companies' access to our capital markets and their ability to invest in the United States, in turn growing and creating jobs.

I look forward to hearing from our witnesses on these legislative proposals.

PREPARED STATEMENT OF RAYMOND J. KEATING

CHIEF ECONOMIST, SMALL BUSINESS AND ENTREPRENEURSHIP COUNCIL

JUNE 26, 2018

Chairman Crapo and Members of the Committee, thank you for hosting this important hearing today on the issue of access to capital. The Small Business and Entrepreneurship Council (SBE Council) is pleased to submit this testimony.

My name is Raymond Keating and I serve as chief economist for the Small Business and Entrepreneurship Council (SBE Council), a nonprofit, nonpartisan advocacy, research, and education organization dedicated to protecting small business and promoting entrepreneurship. For nearly 25 years, SBE Council has worked on a range of private sector and public policy initiatives to strengthen the ecosystem for healthy startup activity and small business growth.

Small Business and Access to Financial Capital

Throughout SBE Council's history, access to capital has been a core issue. Of course, financial capital—whether equity or debt—stands out as a foundational matter for entrepreneurs who are starting up, operating or expanding businesses. However, for many entrepreneurs, gaining access to capital has long been a challenge.

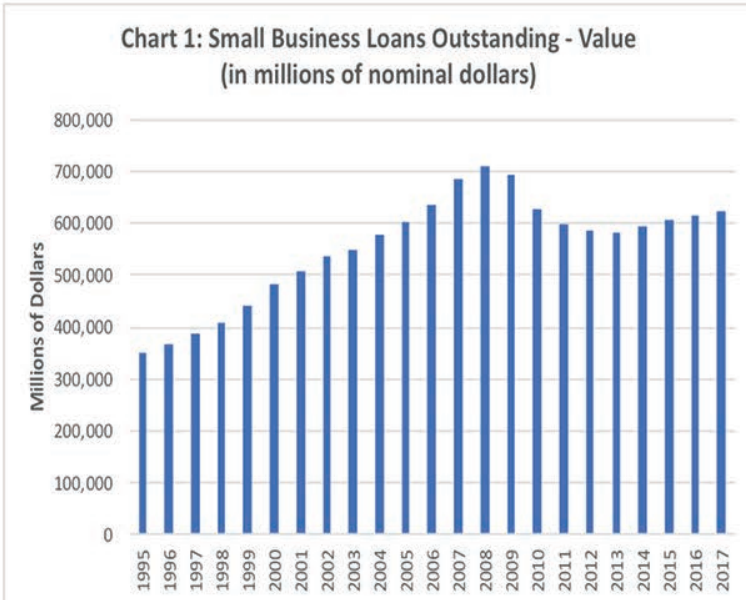
During the financial crisis, the Great Recession and an underperforming recovery, capital became increasingly hard to access from institutional banks and various capital market players. And while matters have improved in recent years, many entrepreneurs continue to struggle with accessing the capital they need to compete and grow.

Small Business Loans. Consider the trends in bank small business loans (less than $1 million) over the past decade or so, as displayed in Charts 1 and 2.

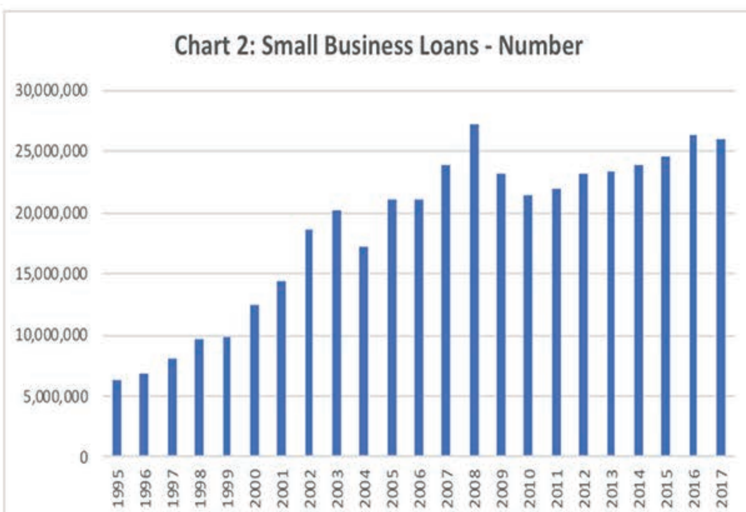
Chart 1 shows that the value of small business loans outstanding hit a high of $711.5 billion in 2008, and subsequently fell for 5 straight years. Growth resumed in 2014, and has continued since. But recovery to the 2008 high is yet to occur, never mind factoring in any additional growth. In fact, the 2017 level of $623.1 billion came in at less than the 2006 level. So, small business loan value has experienced no growth for more than a decade, and consider that these numbers are nominal, so inflation is not even factored in, which would make the picture bleaker.

The small business share of commercial and industrial loan value outstanding registered, for example, 33 percent in 1995, 35 percent in 2004, 30 percent in 2007, and in early 2010, it registered 31 percent. However, the subsequent decline has been rather stark, falling to 20 percent by mid-2015 and remaining at that level since. Looking at nonfarm nonresidential loans, the small business share came in at 52 percent in 1995, and had declined to 39 percent in 2007. And at the end of 2017, the small business share further declined to 20 percent.

As for the number of small business loans, these rose steadily up to 2008 (hitting 27.1 million in 2008 compared to 6.3 million in 1995), and subsequently declined into early 2011 (coming in at 21.3 million) and then working to recover, climbing back to 26.4 million in mid-2017. However, there was a falloff in the second half of 2017, retreating to just below 26 million. Again, the level at the end of 2017 remained below the 2008 level.



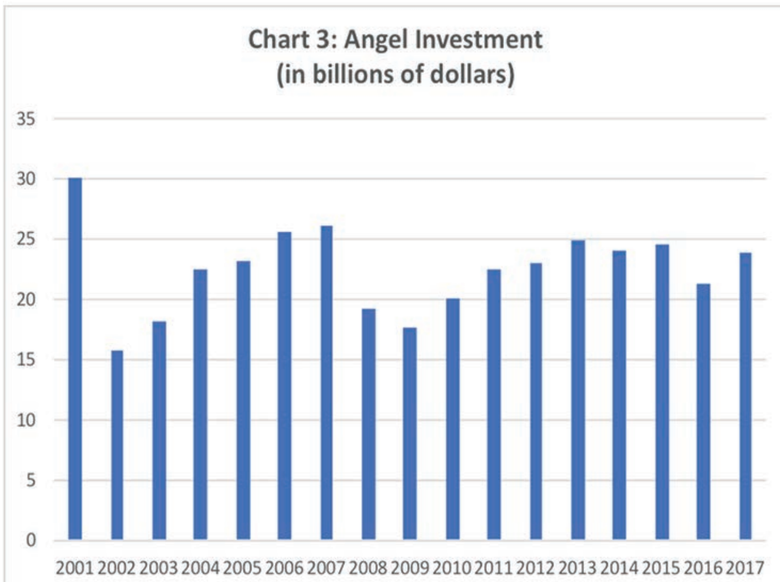
Data Source: Federal Deposit Insurance Corporation, Quarterly Banking Profile



Data Source: Federal Deposit Insurance Corporation, Quarterly Banking Profile

Angel Investment. On the equity side, angel investment stands out as a critical source of funding for start-ups and early-stage businesses. But here, the numbers have been disappointing in recent years.

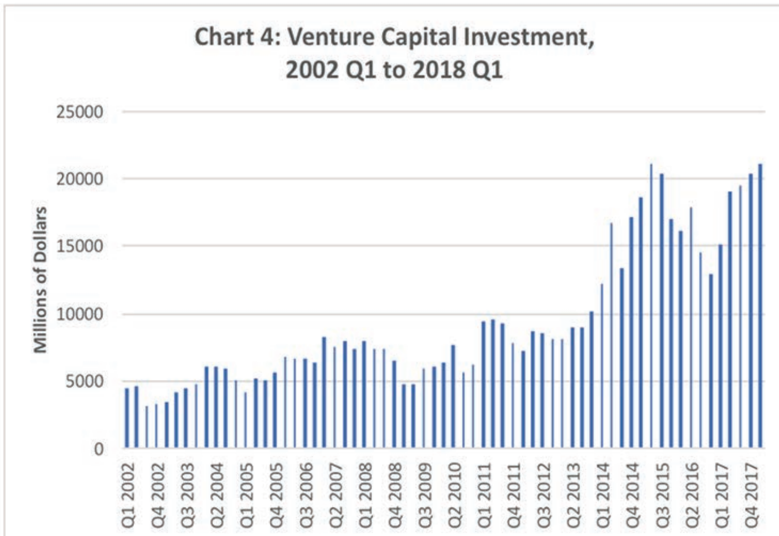
According to numbers from the Center for Venture Research at the University of New Hampshire (as seen in Chart 3), moving past a big drop in angel investment in 2002, coinciding with the aftermath of the 2001 recession (as well as the post–"tech bubble"), growth resumed from 2003 through 2007, with angel investments increasing from $15.7 billion in 2002 to $26 billion in 2007. Subsequently, though, there was a large decline in 2008 and 2009 during the recession. Postrecession growth was underwhelming, growing from $17.6 billion in 2009 to $24.8 billion in 2013. Since then, however, angel investment has stagnated—in fact, actually declining some, coming in at $23.9 billion in 2017.



Source: Center for Venture Research at the University of New Hampshire

As for the number of deals (again, according to the Center for Venture Research at the University of New Hampshire), they grew from 36,000 in 2002 to 57,120 in 2007. After a brief falloff in 2008, growth then resumed, eventually rising to 73,400 in 2014. So, while total angel investment dollars declined and then recovered some from 2007 to 2014, the number of deals grew robustly, pointing to angel investors being active in more deals at lower investment levels. Unfortunately, over the last 2 years—during 2016 and 2017—angel investment dollars declined slightly, and over the last 3 years—2015, 2016, and 2017—the number of deals dropped notably, from 73,400 in 2014 to 61,560 in 2017. The 2017 deal level of 61,560 came in at about the same level as in 2010 (61,900 deals).

Venture Capital. While not an option for most start-ups or very young firms, venture capital investment is an important avenue for innovative firms to raise capital for growth and expansion. The trend on the venture capital front after the Great Recession tends to show more robust growth, even with a decline from the second quarter of 2015 to the fourth quarter of 2016. Since then venture capital investment has bounced back nicely, and over the longer run, growth has been solid since the end of the recession—moving from $4.8 billion in the second quarter of 2009 to $21.2 billion in the first quarter of 2018.



Data Source: PwC/CBInsights MoneyTree™ data explorer, http://www.pwc.com/moneytree

Online Lending and Crowdfunding. Finally, the growth of online lending and crowdfunding for entrepreneurs must be highlighted. SBE Council President and CEO Karen Kerrigan noted the following in her recent testimony (June 21, 2018) before the U.S. House of Representative's Committee on Financial Services:

> There's been improvement in the online lending space as some of the Nation's largest "FinTech" small business lending platforms are quietly helping many entrepreneurs with their capital needs. A May 31, 2018, study, "The Economic Benefits of Online Lending to Small Businesses and the U.S. Economy" reported that just five of the largest lending platforms funded nearly $10 billion in online loans from 2015 to 2017, generating $37.7 billion in gross output, creating 358,911 jobs and $12.6 billion in wages in U.S. communities. The study found that 24 percent of these borrowers are microbusinesses with less than $100,000 in annual sales and two-thirds have less than $500,000 in annual sales. So online lenders are definitely filling an important niche, and small business borrowers are becoming better educated about this type of financing.
>
> The Jumpstart Our Businesses Startup Act (JOBS Act) included solid reforms that have helped boost Initial Public Offerings (IPOs) and deliver many startups the funding they need through regulated crowdfunding (Title III crowdfunding). It took the Securities and Exchange Commission (SEC) four long years to develop and implement the rules around regulated crowdfunding, which is why it has taken longer than expected to get traction through this promising funding approach. Regulation crowdfunding is quietly funding companies and doing what its supporters, like us, hoped it would. To date, there are nearly 1,000 active campaigns (about 600 of those are fully funded), where $132 million has been committed from 133,883 backers (investors). The average raise is $247,456. A wide array of sectors are represented, with application software companies leading the pack followed by beverages (alcoholic), computer hardware, entertainment, and the auto industry.

To sum up, long after the financial crisis hit in late 2008 and the Great Recession came to an official end in mid-2009, the financial capital story for the small business community has been mixed. While having recovered some, small business loans are still well off from where they should be. Angel investment has largely stagnated.

Meanwhile, venture capital has shown solid growth, while online lending and crowdfunding have opened new doors for many entrepreneurs seeking funding.

Regulatory Burdens

Regarding the trends noted above, assorted factors have come into play, including the underperforming economy over a period of a decade and a decline in entrepreneurial activity. Challenges among small community banks also come into play given the important role these institutions play in lending to small businesses. And community banking woes also tie back to the state of the economy, but to Government regulation as well, which, again, always falls heaviest on small businesses, including small banks.

In a May 2016 analysis, I noted the following:

> Consider key points from two recent reports on the state of community banks. A study published in February 2015 by the Harvard Kennedy School's Mossavar–Rahmani Center for Business and Government, titled The State and Fate of Community Banking and authored by Marshall Lux and Robert Greene, looked at the role of community banking in the marketplace, as well as the impact of Dodd–Frank financial regulation law on these small banks.
>
> The authors note that "community banks provide 51 percent of small business loans," and quote William Grant, then chairman of the Community Bankers Council of the American Bankers Association, pointing out, "The cost of regulatory compliance as a share of operating expenses is two-and-a-half times greater for small banks than for large banks."
>
> As for the Dodd–Frank impact, the authors note, "Community banks (defined as banks with less than $10 billion in assets) withstood the financial crisis of 2008—with sizeable but not major losses in market share—shedding 6 percent of their share of U.S. banking assets between the second quarter of 2006 and mid-2010 . . . But since the second quarter of 2010, around the time of the Dodd–Frank Wall Street Reform and Consumer Protection Act's passage, we found community banks' share of assets has shrunk drastically—over 12 percent." They go on to observe: "Interestingly, community banks' vitality has been challenged more in the years after Dodd–Frank than in the years during the crisis."
>
> And at another point, they state: "[C]ommunity bank consolidation trends have almost doubled since the passage of Dodd–Frank, relative to the Q2 2006 and Q2 2010 time frame, which includes the crisis period." The authors added: "As the GAO reports, regulators, industry participants, and Fed studies all find that consolidation is likely driven by regulatory economies of scale—larger banks are better suited to handle heightened regulatory burdens than are smaller banks, causing the average costs of community banks to be higher."
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> As noted in a March 2015 report from the Federal Reserve Bank of Richmond, the sizeable decline in the number of community banks from 2007 to 2013—shrinking by 41 percent—was not only about community bank failures, but about "an unprecedented collapse in new bank entry."
>
> It is noted: "This collapse in new bank entry has no precedent during the past 50 years, and it could have significant economic repercussions. In particular, the decline in new bank entry disproportionately decreases the number of community banks because most new banks start small. Since small banks have a comparative advantage in lending to small businesses, their declining number could affect the allocation of credit to different sectors in the economy."
>
> Potential issues include the state of the economy and Federal Reserve policymaking: "An important factor in bank profitability is the net interest margin, or the spread between deposit rates and lending rates. The Fed's policy of keeping the Federal funds rate near zero since 2008 has pushed lending rates down, which has kept the net interest margin relatively small. Adams and Gramlich [of the Federal Reserve Board of Governors] estimate that this low interest rate environment coupled with weak demand for banking services accounts for as much as 80 percent of the decline in bank entry in recent years. However, a literal interpretation of their model would predict that even if the net interest margin and economic conditions recovered to 2006 levels, there still would be almost no new bank entry, suggesting that other factors are also important for explaining the recent decline."

> The authors write: "Banking scholars also have found that new entries are more likely when there are fewer regulatory restrictions. After the financial crisis, the number of new banking regulations increased with the passage of legislation such as the Dodd–Frank Act. Such regulations may be particularly burdensome for small banks that are just getting started."
>
> The Richmond Fed report concludes: "If de novos [i.e., newly formed banks] are absent due to the low interest rate environment and weak economic recovery, then entry should increase as the economy improves and the Fed raises interest rates. If regulatory costs are the driving force behind low entry rates, then future entry will depend on how those costs change over time."

Writing in the American Banker in October 2017, Camden R. Fine, then-president and CEO of the Independent Community Bankers of America, echoed some of these points. He explained:

> Community banks are highly capitalized, so they're better prepared than their larger competitors for economic crises. And as local institutions, they reinvest in their communities and channel loans to their depositors' neighborhoods . . . promoting localized growth that radiates out to the broader economy. Community banks have been instrumental in helping the Nation recover from the financial crisis and economic downturn, yet their numbers continue to dwindle, declining by roughly 1,500 since 2009. As the only physical banking presence in nearly one in five of the Nation's 3,000 counties, this lifeline to many American families is at risk.
>
> The mere trickle of de novo banks entering the market exacerbates the problem. The number of bank applications has plummeted from more than 100 per year before the crisis to just a handful since 2009 . . . posing tangible risks to financial services access and economic growth in communities overlooked by larger institutions.
>
> Regulatory burden plays no small part in the growing consolidation. A new survey from the Federal Reserve and Conference of State Bank Supervisors found that community bank compliance costs have increased by nearly $1 billion in the past 2 years to roughly $5.4 billion, or 24 percent of community bank net income. Of the respondents who said they considered an acquisition offer in the past year, virtually all (96.7 percent) said regulatory costs were a very important, important or moderately important reason. Further, the Federal Reserve Bank of Richmond has found that regulatory costs play a key role in the recent dearth of applications to form new community banks.

Efforts To Expand Access to Financial Capital

Reform and relief efforts to clear away obstacles and reduce costs for lenders, investors, entrepreneurs and small businesses on the financial capital front are most welcome. For example, SBE Council supports the following bills being discussed today:

S. 588 Helping Angels Lead Our Startups Act or the HALOS Act—This bill clarifies that startups and entrepreneurs can showcase their ideas and businesses at events designed to connect them with potential investors. It clarifies the rules about "demo days" and similar events hosted by universities, Government, accelerators and other entities that help entrepreneurs network, make connections, and identify funding for their enterprises. As noted in the joint statement released by the Senate bill's sponsors: "In order for startups to secure capital and grow their businesses, entrepreneurs often attend 'demo days.' or conferences to showcase their business model in front of investors like 'angel investors' and venture capitalists. It is estimated that angel investors provide 90 percent of outside equity to help grow these young businesses. Unfortunately, recent regulations now require excessive hurdles for angel investors, deterring them from participating in demo days. The HALOS Act would preserve important investor vetting processes without forcing startups to jump through unnecessary hoops to get the investments they need to grow and create new jobs." U.S. Senator Chris Murphy (D-CT) stated, "I'm reintroducing the HALOS Act because the most important thing we can do to help local entrepreneurs is knock down road blocks and make it easier for angel investors to put capital behind them."

S. 2126 Fostering Innovation Act of 2017—Sensibly extends an exemption allowed for in the JOBS Act to growing companies whose business models require more regulatory flexibility, and thus will enable greater success. Extends the JOBS Act's

SOX 404(b) exemption for an additional 5 years for former emerging growth companies (EGCs) that maintain a public float below $700 million and average annual revenues below $50 million. As Senator Gary Peters (D-MI) has observed, "This bipartisan, commonsense legislation would cut red tape for emerging biotechnology companies so they can focus their resources on the critical research and development that will provide innovative treatments and save lives."

S. 2347 Encouraging Public Offerings Act of 2018—As U.S. Chris Van Hollen (D-MD) has pointed out, "Many emerging businesses find that the process of going public is too complex and expensive." Given that reality, this bill would streamline the process by allowing an issuer communicate with potential investors to "test the waters" in terms of gauging interest in a contemplated securities offering, either before or after the filing of a registration statement, and allowing an issuer to submit a confidential draft registration statement to the Securities and Exchange Commission for review prior to public filing or within one year after the initial public offering or registration. U.S. Senator Thom Tillis (R-NC) correctly observed, "IPOs give companies crucial access to our capital markets, and yield the potential to create thousands of jobs. When private companies consider going public, we should be doing everything possible to make this process easy and to encourage it, without jeopardizing investor protections."

S. 3004 Small Business Audit Correction Act of 2018—As is clear from the data and a wide array of studies, regulatory burdens fall heaviest and with greatest consequence on small businesses. This legislation would redress the Dodd–Frank requirement that all investment brokers and dealers, no matter their size, must hire a Public Company Accounting Oversight Board (PCAOB)-registered audit firm to conduct audits that use complex guidelines designed for larger, public companies. As noted in the statement from Senators Tom Cotton (R-AR) and Doug Jones (D-AL), "This requirement is devastating for small investment firms . . . These firms are closing at an alarming rate, in part due to skyrocketing audit costs required by a rule that is illogical for firms that don't hold customer assets. The Small Business Audit Correction Act would exempt privately held, small noncustodial brokers and dealers in good standing from the requirement to hire a Public Company Accounting Oversight Board (PCAOB)-registered audit firm to meet their annual SEA Rule 17a-5 reporting obligation and would instead reinstate the previous regulatory audit requirements."

S. 2765 RBIC Advisers Relief Act of 2018—This bill would reduce unnecessary costs by amending the Investment Advisers Act of 1940 to exempt investment advisers who solely advise certain rural business investment companies.

In addition to these pieces of legislation, several other measures would expand access to capital for entrepreneurs and small businesses. In SBE Council's "2018 Policy Agenda for Entrepreneurs and Small Businesses—Issue Two: Access to Capital", assorted additional pro- small-business measures were highlighted, including:

H.R. 477 Small Business Mergers, Acquisitions, Sales and Brokerage Simplification Act of 2017—H.R. 477 reduces regulatory costs associated with the sale and purchase of small, privately held companies. Current law forces broker dealers to register with the Security and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and one or more States at substantial costs. This results in higher transaction costs for many entrepreneurs who want or need to sell their business.

H.R. 2201 Micro Offering Safe Harbor Act—H.R. 2201 would exempt from registration requirements with the Securities and Exchange Commission (SEC) offerings made only to the entrepreneur's friends and family, to less than 35 purchasers, and when $500,000 or less is raised. The offering would be exempt from State registration and qualification rules, thus reducing costs and complexity. H.R. 2201 would appropriately scale SEC rules and regulatory compliance for our Nation's small businesses, which in turn will provide another practical option for entrepreneurs to raise the capital they need to start or grow their firms.

H.R. 78 SEC Regulatory Accountability Act—H.R. 78 requires the SEC to assess the costs and benefits of regulatory actions and the impacts on small businesses, investor choice, and market liquidity. The bill also requires an exploration of regulatory alternatives, including the option of not regulating, to maximize the net benefits of SEC rulemakings. Having SEC periodically review its regulations is critically important as cumulative and outdated regulation put U.S. capital markets at a competitive disadvantage.

Other Bipartisan Proposals on the Move—There is movement in the U.S. House on several bipartisan bills that are also strongly supported by SBE Council. For example, the "Main Street Growth Act", H.R. 5877, would allow for the creation of venture exchanges, which would provide a tailored trading platform for small issuers and emerging growth companies (EGCs). The "Modernizing Disclosures for Investors Act", H.R. 5970, requires the SEC to provide a report to Congress with a cost–benefit analysis of EGCs' use of SEC Form 10-Q and recommendations for decreasing costs, increasing transparency, and increasing efficiency of quarterly financial reporting by emerging growth companies. Both of these bills advanced out of the Financial Services Committee unanimously. Another bill also recently reported out of the committee, the "Helping Startups Continue to Grow Act", H.R. 6130, would provide for a 5-year extension of certain Security Exchange Act exemptions and reduced disclosure requirements for companies designated as EGCs and will continue to remain as such but for the 5-year restriction on EGCs. Under Title I of the JOBS Act, the IPO "on-ramp" for EGCs provides exemptions and provisions that make sense given the size and development of these small firms. The scaling of rules and exemptions from certain disclosure requirements for EGCs have reduced compliance and regulatory burdens, which have benefited these promising small firms. Each of these bills work to modernize and streamline rules, or make important fixes, which will make the capital markets work better for small businesses and improve U.S. capital formation.

Mobilizing More Capital to Startups and Small Businesses—As noted in my testimony, regulated (Title III) crowdfunding is beginning to gain traction in the marketplace. Refining some of rules would help many entrepreneurs tap into this promising funding option. Some of the reforms supported by SBE Council include raising the amount that can be raised (which is currently $1 million), allowing issuers to "test the waters," allowing for special (or single) purpose vehicles, providing simplified rules for advertising, legal clarity for platforms, and removing the caps for accredited investors, among other changes.

Congress is updating thresholds across many areas of the law, and the same needs to be done with Section 1224 Small Business Stock, which allows investors to deduct losses taken on investments in C Corp startups. Qualified Small Business tax (loss) treatment under Section 1244 of the I.R.S. code (QSB 1244) was passed as part of the Small Business Investment Company Act of 1958, the spirit of which was to mobilize more capital into innovate startups. The current thresholds were last updated in 1978, which are: the first $1,000,000 of outside, individual taxpayer(s) (angel investors) capital receives 1244 treatment; $100,000 per year of 1244 losses deductible against ordinary income (for joint tax returns); $50,000 per year of 1244 losses deductible against ordinary income (for single filers). The Consumer Price Index has risen 363 percent since 1978. If the above thresholds were inflation adjusted, the levels would be: $3,630,000 of outside investors' capital would qualify for de-risking under 1244; $363,000 per year of 1244 losses could be deductible for joint filers: $181,500 per year for single filers. These changes would be consistent with the laudable changes recently made to the QSB 1202 laws, which now provide for the first $10M of profits that qualify under 1202 to be excluded from taxes.

This change can help up-and-coming entrepreneurial ecosystems outside Silicon Valley as well as Opportunity Zones where many new investors and family offices are interested in impact investing.

Capital Gains Tax Relief. Finally, it must be noted that capital gains tax relief is needed to boost access to capital for the entrepreneurial sector of our economy, and further enhance economic, income, and employment growth. One key measure would be reducing the capital gains tax rate—such as from the current rate on individuals of 23.8 percent to 10 percent or 15 percent—while also indexing gains for inflation so that the real capital gains tax rate does not climb higher than the stated nominal rate. In the end, the capital gains tax raises diminishes the returns on and disincentivizes investment and entrepreneurship. Reduce the capital gains tax substantially, and that would be good news for the risk taking that drives the economy forward.

Thank you for your time and attention. I look forward to your questions and further discussion.

PREPARED STATEMENT OF MERCER E. BULLARD

BUTLER SNOW LECTURER AND PROFESSOR OF LAW, UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW

JUNE 26, 2018

Chairman Crapo, Ranking Member Brown, members of the Committee, it is an honor and a privilege to appear before the Committee today. Thank you for this opportunity. I am a Professor of Law at the University of Mississippi School of Law, where I teach corporate and securities law. I have previously practiced securities law at the law firm of WilmerHale, been an Assistant Chief Counsel at the SEC, and testified before Congress on securities law issues on 24 prior occasions.

This testimony discusses aspects of four bills before the Committee:

- S. 2126, Fostering Innovation Act of 2017;
- S. 588, Helping Angels Lead Our Startups Act or the HALOS Act;
- S. 2347, Encouraging Public Offerings Act of 2018; and
- S. 1117, Consumer Financial Choice and Capital Markets Protection Act of 2017.

Executive Summary

One premise of the JOBS Act and some of the bills presented today is that excessive regulation wrought by the Sarbanes-Oxley and Dodd-Frank Acts has damaged U.S. capital markets by causing a dramatic decline in the number of U.S. IPOs and public companies. This is a myth. The facts simply do not support this claim. First, the analytical methods applied by those who make this claim are not empirically valid. Second, even if they were empirically valid, one could make an even more persuasive claim that regulation has *improved* the market for public companies in the U.S. The market capitalization of U.S.-listed companies has followed a steady upward climb interrupted only by market crashes and scandals. In both of the instances of short-term declines in market capitalization this century, it was balanced, effective regulation – the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010 – that helped restore investor confidence and return public market wealth to an upward path. At the same time that Congress claims to support increasing the number of IPOs and public companies, it proposes to de-regulate private capital markets, thereby providing greater incentives for companies to stay private.

The Fostering Innovation Act is fundamentally inconsistent with primary premise of the regulation of sales of securities to retail investors, which is that investors will be provided with access to material information about the offering and that the integrity of the information has been verified by an independent party. The Act will further fracture the meaning of "U.S. public company" – the world's gold standard – and continue to dilute the value of the U.S. financial markets. The Act's premise – that the additional cost of a 404(b) audit for companies with up to a ***$699 million public float*** is overly burdensome – has no sound basis. The academic literature shows that the economic benefits of Section 404(b) outweigh the costs, and the SEC has found that those costs have been steadily declining. The Act would likely affect less than 2% of public companies and would have no material effect on the number of IPOs or public companies.

The HALOS Act represents the de facto repeal of offering regulation. The Act will allow virtually any type of public entity to advertise and host an event that can be attended by any person for the purpose of any issuer pitching a securities offering. The Act permits public notices that specifically advertise a forum as a securities offering pitch (with only references to a "specific offering of security by" an issuer being prohibited). The Act purports to require that "no specific information regarding an offering of securities by the issuer [be] communicated or distributed by or on behalf of the issuer," and then creates an exception that covers all of the essential specific information that an issuer would want to communicate regarding its offering. The Act fits a pattern of designing the system of private and public offerings so as to give informational advantages to large investors that are denied to retail investors. If all offerings are permitted to be public, all public offering information provided to investors should be publicly available.

The Encouraging Public Offerings Act would amend exemptions that will exacerbate the incoherent erosion of the distinction between registered and unregistered offerings and further disadvantage of retail investors vis-a-vis large investors. Expanding the category of issuers that are permitted to keep their registration statement secret while engaging in roadshows facilitates the communication of fraudulent or inaccurate information prior to the filing of a registration statement and provides large investors with a distinct informational advantage over retail investors. Current law permits an issuer to file a public registration statement a mere 15 days before its IPO and to make materials amendment even closer to that date. This already provides inadequate time for investors to evaluate an issuer's registration statement. The Act's shortening the time period will make this problem worse.

I testified before Congress in opposition to money market fund reforms before they were adopted by the SEC. My views have not changed, but circumstances have, and in light of those changed circumstances I cannot support the Consumer Financial Choice and Capital Markets Protection Act of 2017. My position is based on four concerns. First, in my opinion, there has not been a thorough empirical analysis of the likely effect of the Act. I recommend that Congress ask the SEC to conduct such an analysis. Second, I do not have faith in the SEC's ability to manage money market fund risk based on its actions before and after the Reserve Fund failed. Third, I am concerned that banking regulators would seize upon another money market fund failure (albeit highly unlikely) as an excuse to impose new regulations on all funds that could cripple America's mutual fund sector. Finally, Congress has stripped banking regulators of powers necessary for them to take appropriate emergency action in the event of another severe liquidity event, and the Act would impose even greater restrictions.

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I. The Myth of the Regulation's Adverse Effect on IPOs and Public Companies

One premise of the JOBS Act and some of the bills presented today is that excessive regulation wrought by the Sarbanes-Oxley and Dodd-Frank Act's has damaged U.S. capital markets by causing a dramatic decline in the number of U.S. IPOs and public companies. This is a myth.[1] The facts simply do not support this claim. First, the analytical methods applied by those who make this claim are not empirically valid. Second, even if they were empirically valid, one could make an even more persuasive claim that regulation has *improved* the market for public companies in the U.S. The market capitalization of U.S.-listed companies has followed a steady upward climb interrupted only by market crashes and scandals. In both of the instances of short-term declines in market capitalization this century, it was balanced, effective regulation – the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010 – that helped restore investor confidence and return public market wealth to an upward path.

The most harmful myth underlying some of today's bills is the apparent acceptance of invalid methodologies. Drawing a direct causal relationship between the number of U.S. IPOs and regulation and the Sarbanes-Oxley and Dodd-Frank Acts are not statistically valid. The incidence of IPOs depends on a wide variety of factors, many of which are generally unrelated.[2] There are just as many reasonable arguments that regulation has resulted in *more* IPOs and *more* public companies than there otherwise would have been.[3] But these conclusions would be just as statistically invalid as contrary conclusions.

Even if drawing such causal conclusions were statistically valid, the data do not support the conclusion that the Sarbanes-Oxley and Dodd-Frank Acts harmed public markets. For example, the bulk of the significant decline in U.S. IPOs from 1996 to the present occurred *before* the enactment of the Acts. The JOBS Act purported to be designed to increase the number of U.S. IPOs, but the number of U.S. IPOs is *lower* now than it was when the JOBS Act was passed. Critics contend that Section 404(b) of the Sarbanes-Oxley Act, the regulatory requirement most often cited as suppressing IPO activity, has made public company status too expensive for small firms, but ***Section 404(b) has never applied to***

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[1] Another influential myth is the outsized contribution that small businesses make to job creation. This topic is beyond the scope of my testimony other than to note that: (1) the relevant measure of value should be *net* job-creation, not job-creation, (2) many studies data show that small companies are *less effective* job-creators than are large companies, and (3) companies often increase net social wealth through *job-destruction* by producing goods and services at lower costs with fewer workers (and the efficient allocation of capital is necessary for quickly developing the market of resulting new jobs, such as servicing robots). *See, e.g.,* Robert Atkinson and Michael Lind, Big is Beautiful: Debunking the Myth of Small Business (MIT Press 2018); John Haltiwanger, Ron S. Jarmin and Javier Miranda, *Who Creates Jobs? Small versus Large versus Young*, 95 The Review of Economics and Statistics 347 (May 2013) (finding no systematic relationship between firm size and growth); Steven J. Davis, John Haltiwanger, and Scott Schuh, *Small Business and Job Creation: Dissecting the Myth and reassessing the Facts*, NBER Working Paper 4492 (October 1993). Some claims are so absurd as to be offensive, such as the suggestion that growing income gap between rich and poor Americans may be attributable to the American investors "being shut out of the most attractive offerings." *See* The Promise of Market Reform, NASDAQ at 2 (2017) ("income inequality could worsen as average investors become increasingly shut out of the most attractive offerings") (statement of NASDAQ President and CEO Adena Friedman).

[2] *See, e.g.,* Tom Braithwaite. *SEC's Power to Revive IPO Market Limited Without Radical Measures*, On Wall Street (May 12, 2017) ("The dwindling numbers of public companies — down from more than 9,000 20 years ago to fewer than 6,000 today — is caused more by an increase in mergers.") ("*SEC's Power to Revive IPO Market*"); *Access to Capital and Market Liquidity*, Division of Economic and Risk Analysis, SEC at 4 (August 2017) ("*SEC Capital Access Report*" ("It is difficult to disentangle the many contributing factors that influence IPO dynamics.").

[3] An SEC report specifically rejected the hypothesis that "total primary market security issuance is lower after the enactment of the Dodd-Frank Act." *Id.* at 5.

the vast majority of U.S. IPOs or public companies because it has never applied to non-accelerated issuers.

The claim that the number of U.S. IPOs has declined reflects egregious cherry picking. Proponents of weakening regulation invariably choose a year between 1995 and 2000 from which to measure the change in the number of IPOs, but that period represents a significant departure from the average. As the chart below shows, the only year in which the number of IPOs exceeded the 1996 total *was 1969*. Using the reasoning of critics of regulation, the chart demonstrates that from 1974 to 2016 there was an *eight-fold increase* in the number of annual IPOs (from 9 to 78) as a result of enhanced regulation under the Sarbanes-Oxley and Dodd-Frank Acts. But this claim has no more empirical validity than the claim that these statutes have caused the number of U.S. IPOs to decline.

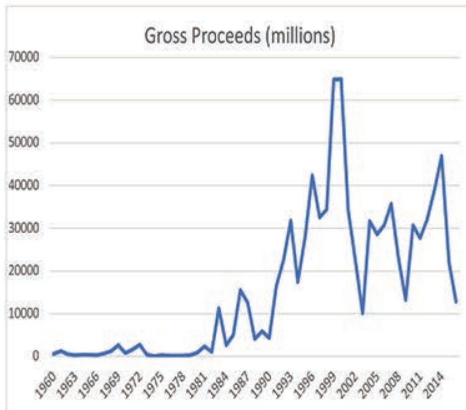
Additionally, the number of U.S. IPOs and the number of U.S. public companies are simply the wrong measures. Critics use these data to suggest that less capital is being raised in U.S. IPOs and less capital is represented by companies listed on U.S. exchanges. Both claims are false.

As the chart below shows, gross IPO proceeds[4] have followed a consistent zigzag pattern since the early nineties, before which gross proceeds were substantially lower than they are today. The aberrational high years of 1999 and 2000 included IPOs of Internet stocks with grossly inflated valuations that substantially contributed the market decline from 2000 to 2002. The amount in the years immediately before and immediately after the 2000 – 2002 period was the same ($34.4 and 34.2 billion, respectively) and, notably, those amounts are substantially lower than in the post-Dodd-Frank-Act of 2014 ($47.0 billion).[5] ***Excluding the Internet bubbles years of 1999 and 2000, 2014 set the all-time***

[4] I refer to gross proceeds in IPOs because that is the data that is accessible, but it is not an accurate measure of the amount raised in IPOs. Gross proceeds are typically substantially more than the amount of capital raised by an issuer. The amount of gross proceeds of an IPO is reduced by various expenses and, more significantly, by proceeds diverted to selling shareholders. An important but generally ignored function of IPOs is the freeing up of capital of early-stage investors that can be recycled back into the start-up market.

[5] *See* Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 200 for Issuers with Public Float Between $75 and $250 Million, Office of Chief Accountant, SEC at 94 (2011) ("2011 SEC Report") ("If 1999 and 2000 are eliminated as bubble years, the aggregate proceeds raised by IPOs recovered in 2004 and maintained that level through 2007, despite the drop in number of the number IPOs compared to the pre-2001 era.").

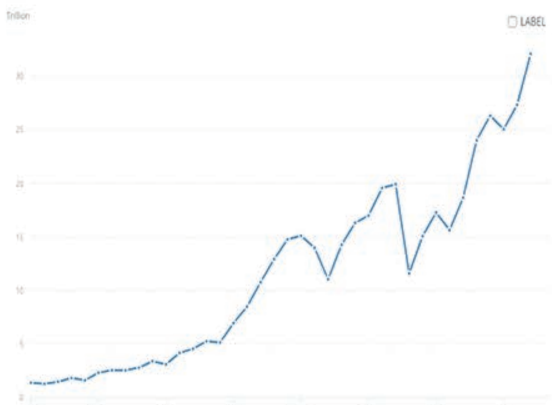
record for IPO gross proceeds. Recent data suggests that that record will be broken this year, with 1Q18 IPO proceeds totaling $15.6 billion,[6] and may even surpass the Internet Bubble's highs. Critics assign intrinsic value the number of IPOs, which is an arbitrary function of a very diverse set of factors, in derogation of the amount of capital actually raised. ***I submit that the success of our public markets in raising capital should be measured by the amount of capital raised.***



[6] Ryan Vlastellica, IPO Proceeds Hit 3-Year High in First Quarter, Fueled by Foreign Companies' Offerings, MarketWatch (Mar. 31, 2018) *available at* https://www.marketwatch.com/story/ipo-proceeds-hit-a-3-year-high-in-the-first-quarter-boosted-by-foreign-companies-2018-03-29.

The amount of capital represented by U.S.-listed companies tells an even more compelling story. ***The total market capitalization of U.S.-listed companies increased from $8.5 trillion in 1996 to $32.1 trillion in 2017, as shown in the chart below.*** The largest short-term declines in U.S.-listed company aggregate market capitalization were concurrent with the crash of the Internet Bubble and the Enron/Worldcom group of accounting scandals in one case, and with the Financial Crisis in the other. Market capitalization *rose* in the wake of the Sarbanes-Oxley and Dodd-Frank Acts. The decline in the number of listed companies ignores the fact that companies are simply much larger than two decades ago, which likely reflects changes in optimal firm size and the probability of a small company being acquired.[7] According the logic of critics, the perceived problem with the number of listed companies would be solved just as well by requiring that all listed companies be split into two.

Market Capitalization of U.S.-Listed Companies
Source: World Bank[8]

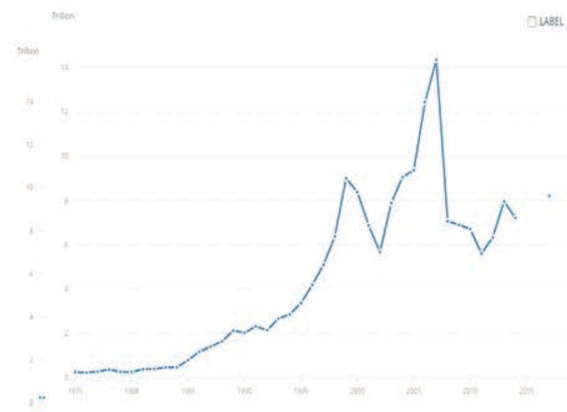


[7] *See* Jay R. Ritter, Xiaohui Gao Bakshi and Zhongyan Zhu, *Where Have All the IPOs Gone?* (August 26, 2013) (published at 48 Journal of Financial and Quantitative Analysis 1663 (2013)) (decline in listings not caused by regulation; finding decline is correlated with the declining relative profitability of smaller firms and the higher incidence of acquisitions) *available at* ssrn.com/abstract=1954788.

[8] *Available at* https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?end=2017&locations=US&start=1980 (last visited June 21, 2018).

In comparison to the market capitalization of European-Union-listed ("EU-listed") companies, the U.S. public company market has been an unmitigated success. As shown in the chart below, from 1996 to 2017, the market capitalization of EU-listed companies rose from $4.2 to $8.2 trillion. In other words during the period in which critics claim that the U.S. public company market has been a failure, the market capitalization of U.S. public companies rose 278% ($8.5 to $32.1 trillion), while the market capitalization of our most advanced competitors' markets rose only 95% ($4.2 to $8.2 trillion). The Financial Crisis had a far more devastating effect on EU-listed than U.S.-listed companies, with the former reaching bottom after a 61% drop and the U.S. reaching bottom after only a 42% decline. After reaching their lows, the US market cap rose 136% ($11.6 to $27.4 trillion), while the EU market cap rose a relatively anemic 46% ($5.6 to $8.2 trillion). If the health of our listed companies is attributable to regulation, then it appears that the Dodd-Frank Act created a large advantage for U.S. public markets.

Market Capitalization of E.U.-Listed Companies
Source: World Bank[9]



[9] *Available at* https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?locations=EU (last visited June 21, 2018). This chart does not render properly on the World Bank's site; it omits the data point for 2016 and the line from 2015 to 2017 (the point at the far right is for 2017).

Thus, EU-listed companies had a substantially larger downturn and substantially weaker recovery after the Financial Crisis.[10] ***From 2007 to 2017, the EU market cap declined 43% ($14.4 to $8.2 trillion) while the U.S. market cap rose 61% ($19.9 to $32.1 trillion), as illustrated in the chart below.***[11]

As the chart shows, more than 70% of the recovery in U.S. market cap during the four years starting in 2007 occurred during the seven years from 2011 to 2017 – ***after the enactment of the Dodd-Frank Act.***[12] If the Dodd-Frank Act could be viewed as having had an effect on confidence in public companies, its effect has been to contribute to an extraordinary increase confidence in U.S. public companies relative to European public companies.

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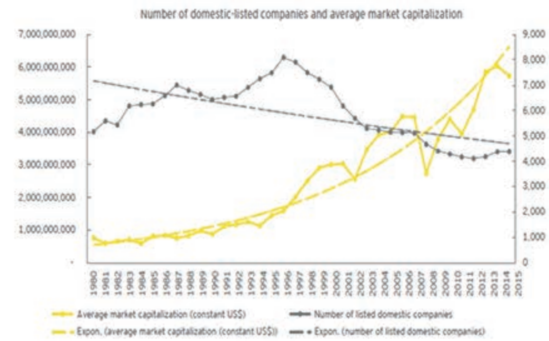
[10] As indicated in the charts, the EU market cap reached bottom in 2011, whereas the U.S. market cap reached bottom in 2008.

[11] Due to the gap noted *supra*, I have assumed equal increases from 2014 to 2015 and 2015 to 2016. *See also* Looking Behind the Declining Number of Public Companies, Ernst & Young at 2 (May 2017) ("Looking Behind the Numbers") ("among the smaller number of foreign companies that do list on an exchange outside their home country, ***twice as many choose U.S. markets as those that list in any other jurisdiction***" (emphasis added)(EY Vice Chair Lee Brorsen); "foreign companies today overwhelmingly choose the U.S. when they list outside of their home markets. Companies based in the U.S. rarely elect to list anywhere else.").

[12] The U.S. market cap rose $5.7 trillion from 2008 to 2010 ($11.6 to $17.3 trillion) and $14.8 trillion from 2010 to 2017 ($17.3 to $32.1 trillion). *See* Looking Behind Numbers, *supra*, at 2 & 3 ("More than half of the decline in the number of public companies since 1996 can be attributed to the post-dot-com bubble era of business failures and delistings that immediately followed an extraordinary number of IPOs" (EY Vice Chair Lee Brorsen); "delisting rates are much lower than immediately the dot-com boom"); Craig Doidge, G. Andrew Karolyi and Rene Stulz, *The U.S. Listing Gap*, Fisher College of Business, WP 2015-03 -07 at 1 (June 2016) (finding lower delisting rates after dot-com boom and delisting rate increased after 1996 "mostly as a result of an unusually high pace of merger activity among public firms").

As shown in the chart below, the large decline in the number of U.S. public companies has been accompanied by a large increase in their average market capitalization.[13]



Source: World Bank, excluding investment funds and trusts.

Nonetheless, critics contend that it is not total wealth that matters but the number of companies representing that wealth, apparently believing that the guiding principle of capitalism is to maximize the *distribution of capital* across the largest number of companies rather than the greatest *creation of capital* by public companies.[14] ***It is not clear why these critics would rather that U.S. public markets be poorer with more public companies than wealthier with fewer public companies.***

Another aspect of the IPO/public company myth is that there is a objectively determinable number of IPOs and public companies that is optimal, and recent levels are lower than that number. Rationally arguing for more IPOs or public companies requires a rational theory of how more IPOs and/or more public companies creates greater social wealth. In terms of the actual *value* of U.S. public companies, ***fewer*** public companies has correlated with ***greater*** net social wealth. The only rationale provided by critics of current regulatory requirements is that some prior larger number of IPOS and public companies over a cherry-picked period is what the number *should* be – simply because the number was larger during that period. The average number of IPOs from 1960 to 2016 was about 227, yet the ubiquitous comparisons to IPOS in the late 1990s implies that critics believe the ideal number would be around twice the average without any rational basis for that claim.

Indeed, there has been a decline in the number of IPOs beginning in 2001. The average from 2001 to 2016 was 114 IPOs, less than half the average of 272 from 1960 to 2000. Five of the six years with the lowest number of IPOs coincided with the market downturns following the bursting of the Internet Bubble and scandals of 2001 – 2002, and the Financial Crisis. The drop-off from 2000 to 2001

[13] Looking Behind the Numbers, *supra*, at 4.

[14] *See* The U.S. Listing Gap, *supra*, at 1 (If the "optimal firm size is increasing as a result of technological changes, . . . the drop in listed firms likely has nothing to do with the benefits and costs of being a public company and might even be a positive development for the economy. ").

alone was from 382 IPOs to 79 IPOs. However, even excluding the years 2001, 2002, 2003, 2008 and 2009 yields an average of 140 IPOs – still barely half of the earlier period's 272 IPOs.

There is no question that there has been a meaningful drop-off in the number of IPOs, but the cause of this drop-off and the separate question of whether this is a positive or negative development are different matters. The total amount of gross IPO proceeds during the 16-year period with half the average number of IPOs was many multiples of the total amount of gross proceeds raised in the preceding 41 years, which means that we are raising much more capital but fewer companies are doing it. The timing of the ups and downs of IPOs seems to reflect market downturns and crises, but it does not fit a theory of regulation-induced declines or increases. As noted above, the data suggest that the decline is due partly to the facts that companies are larger, acquisitions are more frequent, and private capital markets have grown substantially.

A more rational approach might consider the actual amount of wealth represented by the public company market, that is, assuming that what we value is increasing the wealth of public companies rather than distributing wealth among a larger number of public companies. As creators and repositories of wealth, the modern history of U.S.-listed companies has been a virtually unmitigated success. The largest short-term declines and the largest short-term increases in U.S.-listed company value have occurred immediately before and immediately after the enactment of laws that critics claim have had the effect of reducing net social wealth. The JOBS Act and bills currently pending appear to reject the net creation of social wealth as a measure of the health of public company markets, preferring instead to apply the more socialist metric of the number of public companies across which public market wealth is spread.

A rational approach might also consider that the essential difference between registered and unregistered offerings is that the former can be sold without qualification to retail investors. In my opinion, the right number of IPOs and public companies would be the number naturally occurring in a free market (i.e., as set by the forces of supply and demand, rather than being determined by Congress, regulators, issuers or stock exchanges), consistent with investor protection (i.e., ensuring access to, and the integrity of, information about public offerings and public companies). In contrast, the JOBS Act and currently pending bills seek to increase the number of IPOS and public companies by reducing access to and the integrity of information provided to retail investors. (At the same time, Congress is undermining the premise that *unregistered* offerings are *not* made to retail investors.)

The JOBS Act and the currently pending bills create the appearance that claims regarding the effect of the Sarbanes-Oxley and Dodd-Frank Acts on the number of IPOs and public companies are disingenuous – nothing more than the product of interest group politics. ***Congress previously enacted and now again proposes legislation that purports to be intended to increase the number of IPOs and public companies while pairing that legislation with law that will inevitably reduce number of IPOs and public companies.*** Congress has systematically made raising capital through unregistered offerings, which are the principal alternative to conducting an IPO,[15] substantially more attractive,[16] while also claiming a desire to increase the number U.S. IPOs and public companies. For example, the

[15] *Why the Decline in the Number of Listed American Firms Matters*, The Economist (Apr. 22, 2017) ("Airbnb has raised billions from private markets and has 26 external investors. It will make gross operating profits of $450m this year . . .") *available at* https://www.economist.com/business/2017/04/22/why-the-decline-in-the-number-of-listed-american-firms-matters.

[16] *See* Looking Behind the Numbers, *supra*, at 2 (in recent years, "we find that a surge in private capital and the unique characteristics of many of today's new companies have made it easier to grow outside the public equity market for longer than historically was feasible").

JOBS Act created a new exemption for crowdfunding, raised the limit for Reg A offerings from $5 to $50 million and preempted state regulation, and permitted general solicitation and advertising in private offerings.[17] A reporting company is not allowed to use Reg A, which means that a small issuer contemplating raising $50 million in an IPO gives up the possibility of later raising that amount under Reg A.[18] In other words, a private company that seeks to raise $50 million on the public markets surrenders the ability to later raise $50 million in a Reg A offering, but the reverse does not hold.

The JOBS Act also increased the threshold for the number of shareholders that trigger registration by thousands,[19] which has removed a common impetus for becoming a public company.[20]

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[17] *See id.* at 3 ("Legislation enacted over the last five years has made it easier for emerging companies to stay private longer by relaxing certain regulatory requirements and encouraging more private financing."). The SEC Chairman reported that, from the date of the applicable 2015 JOBS Act amendments through March 31, 2018, $798 million was raised under Reg A and $68.7 million through crowdfunding under Reg CF, and that $147 billion was raised under Rule 506 in 2017. *See* Oversight of the U.S. Securities and Exchange Commission, Hearing before the Committee on Financial Services, U.S. House of Representatives at 5 (June 21, 2018) (testimony of SEC Chairman Jay Clayton) *available at* https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission. If the SEC's Reg A estimate is based on Form 1-U, it may substantially understate the amount raised because there is evidence that some Reg A issuers ignore the Form 1-U filing requirement (although the difference may be due to long offer periods). *See* Amit Singh, *A Year End Look at Equity Crowdfunding in 2017*, Stradling: Attorneys at Law at 4 (2018) (finding only 13 Form 1-Us filed for 122 qualified Reg A offerings in 2017); *SEC Capital Access Report*, *supra*, at 6 (reporting amount raised by 56 Reg A issuers during period with 97 qualified offerings). If the SEC estimate is based on Form D filings, it underestimates the amount raised because Rule 506 issuers often ignore the Form D filing requirement and, in any case, they are not required to report the total amount raised. *See id.* at 37 – 38 (acknowledging unreliability of Form D data but basing amount-raised estimate on Form D). Based on my review of crowdfunding issuers that also conducted a Rule 506 offering, issuers frequently ignore the Form D filing requirement. If the SEC estimate of Reg CF offerings is based on Form C-U filings, I can attest that, based on my research, the estimate is not accurate. *See id.* at n. 76 (acknowledging that estimate of amount raised in Reg CF offerings is based on Form C-U). To illustrate the problems with SEC data, in a 2017 report the SEC staff used Form C-U to estimate that, as of January 15, 2017, Form C-Us for 33 offerings had been filed for crowdfunding filings initiated prior to Dec. 31, 2016, which showed an aggregate amount raised of "approximately $10 million." Vladimir Ivanov and Anzhela Knyazeva, U.S. Securities-Based Crowdfunding under Title III of the JOBS Act, SEC Division of Economic and Risk Analysis at 1 (Feb. 28, 2017). My analysis shows the total raised for issuers that filed a Form C-U prior to the SEC's cutoff of January 15 was $9,239,648.30, which is lower than the SEC's total because the total raised is often adjusted downward after the Form C-U has been filed. My analysis also shows that an additional $9,642,880.00 was raised by 30 filers that never filed a Form C-U, and another $7,639,401.65 was raised by filers that filed a Form C-U after the SEC data cutoff of January 15, 2017.

[18] This will no longer be the case when the SEC adopts rules pursuant to Section 508 of the Economic Growth, Regulatory Relief and Consumer Protection Act. Limited data on Reg A+ offerings shows questionable performance to date. *See* Corrie Driebusch and Juliet Chang, *IPO Shortcuts Put Burden on Investors to Identify Risk*, Wall Street Journal (Feb. 6, 2018) *available at* https://www.wsj.com/articles/ipo-shortcuts-put-burden-on-investors-to-identify-risk-1517913000.

[19] As a practical matter, the number-of-shareholders trigger has never applied to the actual number of a company's shareholders as because the SEC interprets it to apply literally to shareholders *of record* (i.e, street name) rather than to actual shareholders. For example, 1 million Americans could own shares of a private company through Merrill Lynch, but they would count as only 1 shareholder under the SEC's interpretation of the shareholder trigger. Historically, private company shares have been held directly, but this may have changed with the expansion of secondary trading markets. *See The Future of Capital Formation,* Hearing before the Representatives Committee on Oversight and Government Reform, U.S. House of Representatives at 10 (May 11, 2011) (testimony of SEC Chairman Mary Schapiro) ("shareholders of most private companies, who generally hold their shares directly").

[20] *See SEC's Power to Revive IPO Market*, *supra* ("At the margin, the last attempt to loosen IPO rules is partly responsible. As part of the sprawling Jobs Act in 2012, lawmakers lifted the level at which private companies are forced to provide public financial statements from 500 to 2,000 shareholders. Hitting the previous limit was a catalyst to previous IPOs including Google and Facebook, which decided that if they went to the trouble of publishing accounts they might as well enjoy the advantages of being public. With the new rules, companies can get older and bigger before feeling any

These reforms are in addition to the expansion of the amount of capital that can be accessed through unregistered offerings due to: (1) the increase in accredited investors since Reg D was adopted in 1982, (2) the shift for retail investors from direct ownership to mutual funds, and (e) the shift for institutional investors to private investment companies (e.g., hedge funds and private equity) and Rule 144A investments.[21] Earlier this year, Congress further disadvantaged IPOs by expanding the potential for (1) private venture capital funding by raising the limit on the number of investors that trigger investment company registration and (2) unregistered offerings to employees by doubling the 12-month dollar limit above which Rule 701 disclosures must be provided (as under Reg A, a company must surrender the ability to make offers to employees under Rule 701 if it becomes a reporting company).[22] Congress has repeatedly provided for investment limits to be raised to match inflation, while leaving the $1 million minimum net worth for accredited investors and $5 million minimum for qualified purchasers unchanged for decades. In 2015, Congress substantially deregulated secondary markets in unregistered securities,[23] and the size of these markets has exploded,[24] further eroding the advantages enjoyed by public companies. Congress has been relentless in making IPOs more unattractive relative to unregistered offerings.

The SEC has found that the excess capital raised in unregistered offerings over registered offerings is growing. It found that capital raised in equity and debt exempt securities offerings exceeded the amount raised in registered offerings by 21.6% from 2009 to 2011, which gap increased to 26% from 2012 to 2016[25] The total amount raised in exempt offerings was $1.16 trillion in 2009, $1.87 trillion in 2015, and $1.68 trillion in 2016.[26] An Ernst & Young biotech expert concisely answered the question of why more companies are staying private as follows: "Because they can."[27]

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pressure."). Similarly, the SEC previously permitted issuers to exclude compensatory stock options from being counted under Section 12(g). 17 C.F.R. 701. *See* Rule 12h-1. The SEC also permits Reg A filers to exclude Reg A securityholders from being counted. *See* Amendments to Regulation A: A Small Entity Compliance Guide*, Securities and Exchange Commission (June 18 2015, as modified May 16, 2016) *available at* https://www.sec.gov/info/smallbus/secg/regulation-a-amendments-secg.shtml. These various interpretive positions and counting rules have rendered the shareholders test under Section 12 of the Exchange Act virtually meaningless.

[21] *See* Looking Behind the Numbers, *supra*, at 3 (investors with large amounts of capital have turned to the private market in search of investment opportunities in high-growth companies"); The Promise of Market Reform, *supra*, at 3 (private capital assets under management increased from $356 billion in 2002 to $1.822 trillion in 2015); Elizabeth de Fontenay, *The Deregulation of Private Capital*, 68 Hastings L.J. 445, 467 (April 2017) ("Over time, Regulation D has proven to be the exception that swallows the rule").

[22] *See* Sections 504 & 507 of the Economic Growth, Regulatory Relief and Consumer Protection Act.

[23] Section 76001 of the Fixing America's Surface Transportation Act ("FAST Act") permitted relatively unrestricted trading of securities held by accredited investors provided that the issuer is not a reporting company (codified at Securities Act Section 4(a)(7), (d) & (e)).

[24] *See Secondary Market for Shares in Pre-IPO Unicorns Is Booming*, Reuters (Dec. 19, 2016) (tradable shares of largest private companies increased from $11 to $35 billion from 2011 to 2016; $1.4 billion in secondary market transactions in 2015, $1.2 billion in 2016) *available at* https://venturebeat.com/2016/12/19/secondary-market-for-shares-in-pre-ipo-unicorns-is-booming/.

[25] *See SEC Capital Access Report*, *supra*, at 5 - 6.

[26] *See id.* at 5.

[27] Proceedings of SEC Small and Emerging Companies Advisory Committee at 120 & 121 (Feb. 15, 2017) (statement of Glen Giovannetti, EY Global Biotechnology).

Today's bills reflect the same contradiction between the asserted purpose of increasing the number of IPOs and public companies while making a further reduction in IPOs and public companies far more likely. The HALOS Act will necessarily *reduce* the number of IPOs and public companies by making it easier for small businesses to identify accredited and non-accredited investors for current and potential offerings. As one commentator has stated:

> [T]he carrot for companies to go public had always been access to cheaper capital because the securities law regime gave public companies the exclusive right to raise money from the general public. Nevertheless, the regulatory thrust in recent decades has been to markedly loosen the restrictions on capital raising and trading on the private side.[28]

The claim that the Sarbanes-Oxley and Dodd-Frank Acts have harmed public markets is based on empirically invalid methodologies and cherry-picked data and reflect the view that is it not net capital creation that matters, but rather the number of IPOs and public companies. The fact that this claim is based on mere mythology is exposed by Congress's repeated enactment of legislation it claims will increase the number of IPOs and public companies while enacting legislation that will likely have the effect of reducing the number of both.

II. Fostering Innovation Act of 2017

The Fostering Innovation Act of 2017 ("FIA/404(b) Act") is fundamentally inconsistent with primary premise of the regulation of sales of securities to retail investors, which is that investors will be provided with access to material information about the offering and that the integrity of the information has been verified by an independent party. The Act will further fracture the meaning of "U.S. public company" – the world's gold standard – and continue to dilute the value of the U.S. financial markets. The Act's premise – that the additional cost of a 404(b) audit for companies with up to a ***$699 million public float*** is overly burdensome – has no sound basis.

The FIA/404(b) Act would extend, for up to about five years, the emerging growth company ("EGC")[29] exemption from Section 404(b)'s requirement of an auditor's attestation as to a public company's assessment of the effectiveness of its internal controls.[30] An EGC's exemption would

[28] *The Deregulation of Private Capital, supra*, at 466.

[29] An EGC is a company that has less than $1.07 billion in gross annual revenue. A company generally remains an EGC until it has more than $1.07 billion in gross annual revenue, the end of the fiscal year in the year of fifth anniversary of the EGC's IPO, or – as is more likely -- it becomes a large accelerated filer (i.e., has a $700 million float as of the end of the second quarter of its fiscal year). *See* 17 C.F.R. § 240.12b-2.

[30] Section 404(a) of the Act requires an internal control report that includes an assessment of the effectiveness of a company's financial reporting internal control structure and procedures. Section 404(b) requires an auditor's attestation as to this 404(a) assessment.

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

(a) RULES REQUIRED.—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—

normally expire no later the end of the fiscal year following the fifth anniversary of its IPO (a "five-year EGC"), but the Act would temporarily extend the exemption for a non-large-accelerated-filer, five-year EGC that has less than $50 million in 3-year average gross fiscal year revenues. The temporary exemption would run until the earlier of the end of a fiscal year in which the company's 3-year average gross revenues exceeds $50 million and the date that it becomes a large accelerated filer, but in no event later than the tenth anniversary of its IPO.

It is not clear how the FIA/404(b) Act will facilitate capital formation or, more precisely, increase the number of public companies. First, it will apply to only a narrow sliver of companies. The SEC and subsequently the Dodd-Frank Act previously exempted non-accelerated filers from Section 404(b). This exemption covers companies with a public float of less than $75 million, which means that five-year EGCs that have less than a $75 million float would be unaffected by the Act. The Act will extend the 404(b) exemption only for EGCs that have a public float of at least $75 million *and* have 3-year average gross annual revenues of less than $50 million.[31] The category of above-$75-million-float, below-$50-million-in-revenues constitutes a narrow cross-section of companies.

This narrow cross-section would be further reduced because the Act applies only to EGCs that conducted their IPO in the preceding five years. There were about 750 IPOs over the last five calendar years, of which about 600 were EGCs.[32] So it would be only the above-$75-million-float, below-$50-million-in-revenues companies in this subset of 600 EGCs that remained EGCs for which the Act would temporarily extend the 404(b) exemption. It would not be surprising if less than a few dozen of the 4,000+ that are listed in the U.S. fit these criteria.

The CFO of aTyr Pharma reportedly testified that the FIA/404(b) Act would affect about 200 biotech companies,[33] but the actual number could not be remotely close to 200. Biotech

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(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Section 404, Sarbanes-Oxley Act of 2002.

[31] Companies can avoid reaching the $75 million cutoff by manipulating their public float, in some cases illegally. *See* 2017 SEC Report at 94 – 95. Thus, some companies avoid the attestation by engaging in the kind of accounting abuses that an attestation would deter or detect. Creating a $50 million cutoff for a 404(b) exemption will likely trigger similarly manipulative conduct. It would be preferable – whatever the cutoff is – to limit it to a single metric and to a metric to which GAAP are not overly susceptible. As discussed *infra* in footnote 37, the trigger for becoming an accelerated filer is arbitrary.

[32] Lia Der Marderosian, 2017 IPO Report (May 25, 2017) (85% of IPOs from 2012 to 2016 involved an EGC) *available at* https://corpgov.law.harvard.edu/2017/05/25/2017-ipo-report/.

[33] *See Lawmakers Asked to Broaden Sarbanes-Oxley Section 404(b) Exemption*, Reuters (July 19, 2017)("*Lawmakers Asked to Broaden*") *available at* https://tax.thomsonreuters.com/media-resources/news-media-resources/checkpoint-news/daily-

companies do, in fact, make up a large percentage of IPOs, but there were only about 200 biotech IPOs during the entire five-year period from 2013 through 2017.[34] It is obvious that not every one of these companies will have started as EGCS and, five years after their IPOs, (1) have continued to be EGCs, (2) not have been acquired or gone bankrupt, (3) have a market cap of between $75 and 700 million, and (4) have 3-year average gross revenues of less than $50 million (an "FIA/404(b) company").

I reviewed the current status of 25 biotech companies that conducted IPOs in the first seven months of 2013.[35] These companies would or would have become five-year EGCs around the date of this hearing, so this group provides a small sample of the number of companies that might be eligible if the FIA/404(b) had been law in the first half of this year. Of these 25 companies, 9 had become large accelerated filers, 5 were acquired, 2 were non-accelerated filers, 2 had 3-year average gross revenues in excess of $50 million, and 1 went bankrupt.[36] Of the remaining 6, 2 had ceased to be EGCs, leaving only 4 of the original 25 (16%) for which the FIA/404(b) Act would provide a temporary 404(b) extension.[37] Applying this percentage to the 200 biotech IPOs implies that the Act would exempt 32, a far cry from 200.

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newsstand/lawmakers-asked-to-broaden-sarbanes-oxley-section-404b-exemption/. The article is a bit ambiguous as the purpose of the reference.

[34] There appear to be varying definitions of what constitutes a biotech IPO. John Carroll, *The Best — and Worst — Biotech IPOs in the Class of 2017*, Endpoints News (Aug. 22, 2017) (22 biotech IPOs year-to-date) *available at* https://endpts.com/the-best-and-worst-biotech-ipos-in-the-class-of-2017/ ; Biotech IPOs: Outliers, Value Creation, and the Dispersion of Returns, Life Sci VC (Sep. 27, 2017) (159 biotech IPOs from 2013 through 2016) *available at* https://lifescivc.com/2016/09/biotech-ipos-outliers-value-creation-dispersion-returns/; Brad Loncar, Biotech IPO Class of 2017 (individual investor's blog reporting 40 biotech IPOs in 2017) *available at* http://www.loncarblog.com/biotech-ipos-class-of-2017; Mark Terry, The 2017 Biotech IPO Winners and Losers, BioSpace (Dec. 21, 2017) (44 biotech IPOs in 2017 including healthcare issuers) https://www.biospace.com/article/unique-the-biggest-biotech-ipo-winners-and-losers-in-2017/; Arlene Weintraub, *The Biotech IPO Boom Will Continue, Nasdaq Execs Predict*, Forbes (Nov. 10, 2018) (26 biotech IPOs in 2016; 30 in 2017 to date); John Carroll, *The top 10 biotech IPOs of 2013*, FierceBioTech (undated) (39 biotech IPOs in 2013) *available at* https://www.fiercebiotech.com/special-report/top-10-biotech-ipos-of-2013.

[35] I included 22 biotech IPOs from: Luke Timmerman, *The Biotech IPO Scorecard: Who's Up, Who's Down in 2013*, Exome June 3, 2013) (listing 22 biotech IPOs to date) *available at* https://www.xconomy.com/national/2013/06/03/the-biotech-ipo-scorecard-of-2013-whos-up-whos-down/, and 3 biotech IPOs from other sources. *See* Steven Shore, *Risk Lovers Find Life in Biotechs*, Aust., Financial Rev., 2013 WLNR 21272812 (Aug. 28, 2013) (13 biotech IPOs in 2Q13, which exceeds number in 1Q13); Pamela Taulbee, *A Time to Test Biotechs' Strength*, The Deal, 2013 WLNR 22166341 (Aug. 23, 2013) (16 biotech IPOs to date); *Fate Therapeutics Joins Biotech IPO Conga Line, Reaching for $69M*, Xconomy, 2013 WLNR 20181374 (Aug. 14, 2013) ("30 life sciences companies have successfully gone public, more than double the annual rate of biotech IPOs seen in the wake of the 2008 financial crisis"); Biotechnology Industry Organization News Release, *JOBS Act Breathes New Life into Biotech*, State New Service (Aug. 14, 2013) (23 biotech IPOs as of August 1); David Thomas, *The Return of the Biotech IPO*, Biotechnow (August 5, 2013) (illegible list of 22 biotech IPOs to date)*available at* http://www.biotech-now.org/business-and-investments/inside-bio-ia/2013/08/the-return-of-the-biotech-ipo.

[36] The bankrupt company is Kalobios (of Martin Shkreli fame), which came out of bankruptcy and changed its name to Humanigen. Humanigen is currently a smaller reporting company with a market cap of approximately $61 million; as reconstituted it would still be exempt from Section 404(b). *See* Humanigen Annual Report (Mar. 27, 2018) *available at* https://www.sec.gov/Archives/edgar/data/1293310/000121465918002397/p31318010k.htm.

[37] A company ceases to be an EGC if its public float exceeds $700 million at the end of its 2nd fiscal quarter, i.e., on June 30. One of these companies, based on its 2Q outstanding shares reported in its quarterly report and its trading price on Yahoo Finance, had a public float of approximately $730 million in mid-June 2014 that dropped sharply to $702 million by the end of the month. I have not been able determine whether the company's market cap at the end of 2Q14 was

Approximately 85% of IPOs involve an EGC, so assuming about 750 IPOs from 2013 through 2017, about 600 would have involved EGCs. Of these, about 200 were biotech companies (I have assumed that all biotech IPOs involved an EGC), which leaves 400 non-biotech IPOs. It is very likely that a far lower percentage of these companies than biotech companies would be FIA/404(b) companies. The aTyr's CFO is correct that biotech companies are far more likely to benefit from the FIA/404(b) Act because they have a long gestation period during which they may have zero or de minimis revenues and substantial R&D expenditures (and this is consistent with my review of the filings discussed above). If non-biotech EGCs remain FIA/404(b) Act companies after five years at one-half the rate of biotech companies (8%), another 32 would benefit from the Act, bringing the total to 64 – ***or 1.5% of the 4,336 U.S.-listed companies as of the end of 2017.*** If the non-biotech rate is one-fourth of the biotech rate, the total would be 48. These estimates are better than back-of-the-envelope numbers, but not by much. I submit that Congress should have a more precise estimate of the number of EGCs that would actually benefit from the FIA/404(b) Act before making it law.

Second, the Act is likely to have no effect on behavior of businesses other than to create an incentive to manage revenues so as to remain below the $50 million cutoff and to enable improper accounting practices to continue to go undetected and undeterred. The mere possibility that a 404(b) exemption may continue to be available *five years after its IPO* is not likely to affect an EGC's decision whether to conduct an IPO. It also strains credulity that the availability of a temporary exemption under the Act would affect an EGC's decision, for example, about whether to de-list. The 4 companies cited

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less than $700 million. For example, the company's quarterly reports shows 29,738,391 outstanding shares at the end of 2Q14, and Yahoo Finance shows a closing share price of $23.60 on June 30, 2014, which would reflect a market cap of $701,826,027.60. *See* Oncomed Quarterly Report (Aug. 7, 2014) *available at* https://www.sec.gov/Archives/edgar/data/1302573/000119312514299534/d736146d10q.htm#tx736146_2.; Yahoo Finance (June 21, 2018) *available at* https://finance.yahoo.com/quote/OMED?p=OMED (last visited June 21, 2018); *see also Oncomed Pharmaceuticals Keeps Rising: Up 10.3% in 3 Days*, Global Round Up (July 2, 2014) ($725.5 million market cap). However, a July 2 article states that its closing price was $23.30, which would bring its market cap under $700 million. *See Oncomed Pharmaceuticals SVP Sells 1,500 Shares of Stock*, Am. Banking & Mkt. News (July 1, 2014) ($23.30 closing share price on June 30, 2014 and $688.6 million market cap). The company had a public float of approximately $766 million in mid-June 2015 that dropped sharply to approximately $640 million as of June 29. A July 1 article reports that its share price was $22.50 on June 30, *see* Logan Wallace, *Oncomed Pharmaceuticals VP Sells 1,800 Shares of Stock*, Ticker Report (July 1, 2015), which, when multiplied by its reported 30,116,633 end-of-2Q15 outstanding shares, would imply a market cap of $677,624,242.50. I have assumed that Oncomed is a qualified EGC, although I also note that the SEC has found that companies manipulate their public float in order to affect their regulatory status. *See* 2017 SEC Report at 95 – 96. This manipulation results partly from the ability of issuer's to affect their status by manipulating their trading price one day each year as a consequence of an EGC's market cap being arbitrarily measured as of a single day – the last day of its second fiscal quarter (a company can subsequently return to being a non-large-accelerated filer at the end of the fiscal year, but this does not change the loss of EGC status). This arbitrary trigger produces absurd results, such as allowing a company to remain an EGC even if its average market cap consistently exceeds $700 million, or stripping a company of EGC status if its average market cap is consistently below $700 million. My review of the stock prices of 2013 biotech EGC IPOs suggests that the effect of this arbitrary trigger is much greater for such companies, possibly because, for example, the announcement of approval or non-approval of a drug or device can cause wild swings in market cap. It would be more efficient and fairer to firms such as aTyr to base accelerated status (only for EGC purposes) on, for example, a company's rolling 6-month average market cap, which would prevent briefly aberrant trading from triggering heightened regulatory requirements or allowing companies to escape applicable regulation while also reducing the ability and incentive for companies to manipulate their stock price to maintain their EGC status.

above have raised hundreds of millions of dollars; the additional cost of a Section 404(b) attestation would be vanishingly small in comparison to that amount.[38]

Third, empirical analysis has demonstrated the value of a 404(b) attestation at the same time that the cost of 404(b) compliance has steadily declined. If anything, existing exemptions should be peeled back in order to begin restoring the coherence of public company regulation. The cost savings experienced by the small handful of companies that avail themselves of the FIA/404(b) Act's temporary exemption is likely to be far smaller than losses associated with accounting restatements and the adverse effect on the reputation of U.S. financial markets, the confidence of investors and the integrity of financial reporting.

One incidental benefit of the existing Section 404(b) exemption for non-accelerated filers is that it has provided ample data with which analyze the exemption's effect. Studies have found that firms subject to Section 404(b) have lower restatement rates[39] -- about 2/3 that of non-404(b) firms.[40] Non-accelerated filers have had a substantially higher incidence of adverse management reports.[41] Section 404(b) compliance costs have been declining since an initial increase after the Sarbanes-Oxley Act became law.[42]

Congress has no reason to take the evaluation of Section 404(b)'s demonstrated efficiency away from regulators, as regulators have demonstrated their attentiveness to this issue and take action as appropriate. It was the SEC, not Congress, that exempted non-accelerated filers prior to the Dodd-Frank Act. In 2007, the PCAOB issued guidance on Audit Standard 5,[43] which the SEC found has had the "intended effect of reducing the compliance burden and improving the implementation of Section 404, including the requirements of Section 404(b) for the studied group of issuers."[44] In 2009, the SEC

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[38] The auditing expenses for aTyr were reportedly $270,000, *see Lawmakers Asked to Broaden*, *supra*, and Section 404(b) on average results in an additional expense of 35% of that amount, which would be $94,500. *See* Hongmei Jia, Hong Xie, and David A. Ziebart, An Analysis of the Costs and Benefits of Auditor Attestation of Internal Control over Financial Reporting (October 2014) ("An Analysis of the Costs and Benefits").

[39] *See* A. L. Nagy, *Section 404 Compliance and Financial Reporting Quality*, 24 Accounting Horizons 441 (2010) (negative correlation between Section 404(b) compliance and materially misstated financial statements); Yuping Zhao, Jean C. Bedard and Rani Hoitash, *SOX 404, Auditor Effort, and the Prevention of Financial Report Misstatements* (SOX 404, Auditor Effort, and the Prevention of Financial Report Misstatements (2017) *available at* ssrn.com/abstract=2693619.

[40] *See* 2011 SEC Report, *supra*, at 86 ("Section 404(b)-compliant issuers that reported effective ICFR experienced a financial restatement rate of 5.1%, while Section 404(a)-only issuers experienced a restatement rate of 7.4%" (quoting Audit Analytics, Restatements Disclosed by the Two Types of SOX 404 Issuers: (1) Auditor Attestations Filers and (2) Management-Only Report Filers (Nov. 4, 2009))).

[41] *See id.* at 87 & note 181 (citing Audit Analytics, SOX 404 Dashboard Year 6 Update, Oct. 2010, available at http://www.complianceweek.com/s/documents/AASOX404.pdf; "Audit Analytics report that adding this population of 3,066 Section 404(a) reports to the 3,356 Section 404(b) reports, the adverse percentage of the total population of 6,422 disclosures becomes 14.6%.").

[42] *See id.*

[43] The "expressed purpose of this guidance was to "help auditors apply the provisions of [AS 5] to audits of smaller, less complex public companies" and to provide "direction to auditors on scaling the audit based on a company's size and complexity." *Id.* at 23 (quoting Staff Views - An Audit of Internal Control that is Integrated with an Audit of the Financial Statements: Guidance for Auditors of Smaller Public Companies (Jan. 23, 2009)).

[44] *Id.* at 4.

reported on its findings of widespread support for Section 404(b) attestation and the tangible benefits it provided.[45]

In 2011, the SEC issued a report on ways to reduce the costs and burdens of 404(b) compliance for accelerated and large accelerated issuers. Its conclusion is worth quoting in full:

> The Staff believes that the existing investor protections for accelerated filers to comply with the auditor attestation provisions of Section 404(b) should be maintained (i.e., no new exemptions). There is strong evidence that the auditor's role in auditing the effectiveness of ICFR improves the reliability of internal control disclosures and financial reporting overall and is useful to investors. The Staff did not find any specific evidence that such potential savings would justify the loss of investor protections and benefits to issuers subject to the study, given the auditor's obligations to perform procedures to evaluate internal controls even when the auditor is not performing an integrated audit. Also, while the research regarding the reasons for listing decisions is inconclusive, the evidence does not suggest that granting an exemption to issuers that would expect to have $75-$250 million in public float following an IPO would, by itself, encourage companies in the United States or abroad to list their IPOs in the United States.[46]

This report was required by the Dodd-Frank Act, presumably because Congress wanted the SEC's expert opinion.

In 2013, a General Accounting Office report echoed the SEC's finding that restatements were higher among companies that were exempt from Section 404(b).[47] In 2016, the SEC proposed liberalizing the standards for scaled disclosure by small public companies in order "to promote capital formation and reduce compliance costs for smaller registrants while maintaining investor protections" and again evaluated the cost and burdens of compliance with Section 404(b) in light of more recent research.[48] The proposal will be voted on by the Commission in two days.[49] ***Just last week, Chairman Clayton stated that the Commission was "taking a fresh look at the thresholds that trigger the requirement contained in Section 404(b) of the Sarbanes-Oxley Act to have an auditor provide an attestation report on internal control over financial reporting."***[50] It is not clear why Congress feels the need to pull the rug out from under the SEC.

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[45] *See* SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, SEC Office of Economic Analysis (September 2009) *available at* http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

[46] 2011 SEC Report, *supra*, at 8.

[47] *See* Internal Controls, GAO-13-582 (July 2013).

[48] *Id.* at 10, 24.

[49] *See* Open Meeting Agenda, SEC (June 20, 2018).

[50] Oversight of the U.S. Securities and Exchange Commission, Hearing before the Committee on Financial Services, U.S. House of Representatives at 5 (June 21, 2018) (testimony of SEC Chairman Jay Clayton).

In the meantime, the evidence of Section 404(b)'s value has continued to mount. A 2014 study found that Section 404(b) decreased companies' cost of debt while increasing compliance modestly and that Section 404(b) companies had higher valuation premiums and credit ratings.[51] A 2016 study found that from 2007 to 2014 the cost of Section 404(b) noncompliance ($856 million in lower future earnings) was more than twice the cost of compliance ($338 million) before taking into account an additional $935 million cost arising from the delay in aggregate market value decline due to untimely internal control disclosure.[52]

The FIA/404(b) Act would undermine investor confidence just as it has reached all-time highs. The Center for Audit Quality 2017 Main Street Investor Survey found that 85% of investors have confidence in U.S. capital markets and 83% had confidence in investing in U.S. publicly traded companies – both all-time survey records since the Financial Crisis.[53] In the aftermath of the Crisis, these confidence levels were only 61% and 70%, respectively.[54]

The CAQ's survey also found that:

- 78 percent of investors say they are confident in audited financial information released by publicly held companies, and
- Investors register exceptional degrees of confidence in the ability of external auditors, audit committees, and stock exchanges to fulfill their investor protection roles.[55]

While 85% of investors had confidence in U.S. capital markets, only 54% expressed confidence in capital markets outside the U.S.[56] – ***where Sarbanes-Oxley requirements do not apply.*** Further diluting the basis for investor confidence in U.S. capital markets will weaken this global competitive advantage.

Attacks on Section 404(b) are primarily based on the argument that savings on compliance costs can be invested in a company's core business, such as additional research and development. That is true,

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[51] *See* An Analysis of the Costs and Benefits, *supra.*

[52] *See* Weili Ge, Allison Koester and Sarah McVay, The Benefits and Costs of Sarbanes-Oxley Section 404(b) Exemption: Evidence from Small Firms' Internal Control Disclosures (September 2016). Some commentators fail to acknowledge that an attestation could have any benefit. For example one study contends that the "net compliance costs of Section 404(b) are negative because firms' public float is abnormally bunched just below the $75 million public float cutoff, on the assumption that if the net effect were positive, firms would choose to be above the $75 million. *See* Dhammika Dharmapala, Estimating the Compliance Costs of Securities Regulation: A Bunching Analysis of Sarbanes-Oxley Section 404(b) (October 2016). This analysis provides no meaningful insight into the "net" effect of Section 404(b). The benefit of Section 404(b) compliance is not only an premium on a company's stock price (and a premium based on empirical analysis, not guesses by CEOs), it is also the deterrence and detection of misreporting and fraud. Studies consistently show a higher incidence of restatements among companies that are not subject to Section 404(b), but the study's author appears to assume that this imposes zero cost on investors. The Enron/Worldcom scandals suggests otherwise.

[53] *See* CAQ 2017 Main Street Investor Survey, Center for Audit Quality (October 2017).

[54] *Id.*

[55] *Id.*

[56] CAQ at 4.

but it is an argument equally applicable to the requirement to provide audited financial statements, file quarterly reports, and meet other requirements of being a public company. If the term "public company" is to *mean* something, then the costs of a Section 404(b) exemption must be weighed along with the benefits. Congress has recently made much of the importance of balancing the costs and benefits of regulation. Research generally shows that the cost of higher audit fees is greatly exceeded by the operating losses and inflated valuations that accompany misstated financials. The costs of 404(b) compliance has steadily declined and the SEC has demonstrated a balanced, well-informed approach to evaluating the costs and benefits of the attestation requirement.

Consider again aTyr Pharma, a company that had a $75 million IPO in 2015.[57] It is a good example of the kind of EGC for which the Act might grant a 5-year extension -- an R&D heavy firm with very little revenue but (fleetingly) sufficient float to qualify as an accelerated filer. aTyr went public at $14/share, and quickly shot up 85% to $25.87/share within a month. However, as shown below, the company's stock price declined steadily thereafter, reaching $1.02/share as of early last week.[58]

There is nothing wrong with investors betting on a long-shot and losing – this is a necessary predicate for seeding great companies – but a company should not be granted the privilege of using the title of "public company" and enjoying the prestige of trading on a national stock exchange such as NASDAQ while claiming that the burden of an outside, independent audit of its internal controls is too much. Prior to its IPO, aTyr successfully raised more than $170 million in the private markets[59] and $46 million

[57] The company filed a Form D the month prior to the IPO disclosing that it had obtained $76 million in Reg D financing. aTyr Pharma Form D (Apr. 2, 2015) *available at* https://www.sec.gov/Archives/edgar/data/1339970/000133997015000002/xslFormDX01/primary_doc.xml.

[58] Its public float is approximately $30 million, which would allow it to continue avoiding the attestation requirement indefinitely.

[59] *See* The *Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance*, Hearing before the Subcommittee on Capital Markets, Securities, and Investment, Committee on Financial Services, U.S. House of Representatives (July 18, 2017) (testimony of John Blake, CFO, aTyr Pharma) ("aTyr Testimony").

under Reg D in 2017,[60] in each case without having to comply with public company requirements. It chose to become a listed, public company in order to benefit from that status, but it is unwilling to live up to the higher standard that public company status should entail.

Evaluations of the efficacy of Section 404(b) should be based on a rational evaluation of its actual costs and benefits, not on gross, one-sided mischaracterizations. In 2016, aTyr's CFO testified that:

> Section 404(b) requires an external auditor's attestation of a company's internal financial controls that provides ***little-to-no insight into the health of an emerging biotech company*** – but is very costly for a pre-revenue innovator.[61]

I disagree. And I submit that investors who bought aTyr at its peak and lost 95% of their investment might have preferred that the company -- which spent $144 million on R&D from 2013 through March 2018 -- have spent an additional $100,000 each year to obtain an outside auditor's attestation of effectiveness of its internal controls.

III. Helping Angels Lead our Startups Act ("HALOS Act")

In order to evaluate the HALOS Act, we much consider changes in technology and markets over the last few decades. In 2000, I wrote an article that discussed what modern technology meant for securities regulation. The main point in the article, which is directly relevant here, was as follows:

> Technology has undermined the foundations of the U.S. securities regulatory regime. This regime has long relied on distinctions between private and public sales activities; personal and mass communications; local, interstate and international commerce; trade and settlement times; opening and closing prices; individually tailored and impersonal advice; written and spoken communications; and discretionary and nondiscretionary accounts. These distinctions depend on the existence of computational, temporal, and geographic barriers that have been collapsed by technology.[62]

Since I wrote those words, the effect of technology on each of the listed distinctions has been severe, particularly with respect to "private and public sales activities."

The Securities Act's registration exemption for transactions "not involving any public offering" ("nonpublic offering") has been problematic from its inception. What is "public" is not defined in the Act. Courts established a loose set of criteria in evaluating the availability of the

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[60] The company filed a Form D in 2017 disclosing that it had obtained $46 million in Reg D financing. *See* aTyr Pharma Form D (Sep. 15, 2017) *available at* https://www.sec.gov/Archives/edgar/data/1339970/000133997017000001/xslFormDX01/primary_doc.xml.

[61] aTyr Testimony, *supra* (emphasis added). *See also Lawmakers Asked to Broaden*, *supra* ("John Blake, testifying on behalf of the Biotechnology Innovation Organization, told lawmakers that biotech companies that are still developing drugs do not present the same risk that more established or bigger companies have with their financial reporting systems. In his view, they derive little benefit from the auditor attestation requirements for financial reporting controls.").

[62] Mercer Bullard, *Mutual Fund Portfolio Disclosure in the Internet Era*, wallstreetlawyer.com (Sep. 2000) ("*Internet Era*").

exemption that were unpredictable and inefficient. Even after the SEC established a fairly predictable safe harbor under Rule 506, the meaning of "general solicitation and advertising" activities, which were prohibited by the rule, was never particularly clear. Nonetheless, these activities in principle are clearly inconsistent with the statutory nonpublic offering exemption.

Modern communications technology has exacerbated the indeterminacy of the concept of "general solicitation." Information no longer needs to be delivered; it can be made instantaneously, electronically accessible to billions by pushing a button. The practicability of immediate, universal access to information renders the idea of a "delivery" requirement somewhat quaint. As I wrote in 2000, "technology has reminded us that [regulatory] distinctions are not real, but rather are metaphors we use to create, interpret and enforce rules."[63] And these "metaphors no longer describe the way we do business."[64]

The declining utility of the concept of general solicitation as a regulatory distinction was never more obvious than when it led, in 2011, to Facebook's cancelling the $500 million U.S. leg of a $1 billion private offering.[65] Facebook reportedly cancelled the offering because a private email solicitation to an accredited investor was leaked to and published by the Wall Street Journal. The SEC has declined to disclose what led to Facebook's cancelling the offering, but the prevailing view is that SEC staff communicated to counsel that the appearance of the solicitation in the Journal could be considered general solicitation or advertising, which would have made the Reg D safe harbor unavailable. At a minimum, it was clear that, under the SEC's somewhat cloudy positions, counsel could reasonably have reached this conclusion on their own.[66] I published an article discussing how this Facebook fiasco illustrated a problem the SEC needed to address, but the SEC took no action.[67]

The SEC's inaction unfortunately led Congress to take a hatchet to the nonpublic offering exemption. The JOBS Act required the SEC to authorize general solicitation and advertising under the nonpublic offering exemption despite the fact that these were inherently incompatible concepts. Congress amended Section 4 to provide that no offers or sales under Rule 506 of Reg D may "be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation." In other words, although general solicitation and advertising are quintessentially "public" in nature, Congress chose to cram the square peg of an essentially public offer into the

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[63] *Internet Era*, *supra*.

[64] *Id.*

[65] *See* Mercer Bullard, *Facebook Fiasco Reveals Flaws in Private Offerings*, Morningstar.com (Feb. 10, 2011).

[66] The Future of Capital Formation, Hearing before the Committee on Oversight and Government Reform, U.S. House of Representatives (May 10, 2011) (testimony of SEC Chairman Mary Schapiro) ("when the media frenzy erupted, [Facebook's] concern was that they might not be able to satisfy the requirement that this was not a general solicitation. And so in light of that, I've asked the staff to come back to me with some recommendations on whether we need to look at the requirements of our exemption. When these exemptions were written, nobody thought about media frenzy being the sort of thing that would tip the balance into whether you were engaged in a general solicitation or truly a private offering. And so we -- we are looking at this issue very closely.").

[67] *See id.*

round hold of the nonpublic offering exemption (under the Orwellian header "Consistency in Interpretation").

The JOBS Act further diluted the public-private distinction by authorizing online crowdfunding, raising the Reg A offering limit from $5 to $50 million and precluding state regulation of large Reg A offerings. Crowdfunding sites now offer a combination of crowdfunding, Reg A and Reg D offerings, each with different disclosures and investor eligibility requirements. Crowdfunding issuers have routinely raised capital under the Reg A, Reg D, crowdfunding, and intrastate exemptions, and through donative funding on Kickstarter and Indiegogo. They promote their offerings on Facebook and Twitter.

This mingling of different offerings and freewheeling public distribution has further undermined nonpublic nature of private offerings. The SEC stated in adopting rules implementing the JOBS Act that it would not permit private Reg D solicitations to be conducted through other public offerings.[68] However, it has permitted crowdfunding offerings that receive more than the $1.07 million annual limit to divert investors who are accredited into a parallel private Reg D offering. In other words, accredited investors are being solicited entirely through the online crowdfunding offering – precisely what the SEC stated that it would not allow.

The HALOS Act takes the absurdity of public private offerings to a new level. The JOBS Act states that a general solicitation does not make an offering public in nature, as if those are different things. The HALOS Act drops all pretense and simply declares that general solicitations are not general solicitations (under another Orwellian header: "Clarification of General Solicitation"). The Act will allow virtually any type of public entity to advertise and host an event that can be attended by any person for the purpose of any issuer pitching a securities offering. The "HALOS Act" is a wonderful acronym, but the "Angels" are only a small slice of the likely hosts for these very public roadshows. The Act might be more appropriately named the "Shark Tank in Every College Auditorium" Act. After obtaining the credit card they should not be given, students can stroll over to the offering presentation to sign up to buy stock they have no business owning.[69]

Members of Congress should know better than anyone that modern technology and public media has rendered the idea of a private meeting or presentation a quaint artifact of a long-gone era (see, e.g., the Facebook fiasco above). The idea of a truly limited, in-person roadshow in an age when any member of the audience can livestream the presentation around the world is similarly naïve. As I predicted eighteen years ago, the public-private distinction has gone by the wayside, but I did not expect that both Congress and the SEC would install a Guernica-inspired regulatory canvas in its place.

Ironically the HALOS Act's inclusion of "angel investor group" is wholly superfluous. From a practicing lawyer perspective, it will create substantial uncertainty and impose unnecessary compliance costs. If an angel investor group hosts an event, the issuer presenters will have to be

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[68] *See* Crowdfunding, Securities Act Rel. No. 9974 at 392 (Oct. 30, 2015) ("an issuer conducting a concurrent exempt offering for which general solicitation is not permitted will need to be satisfied that purchasers in that offering were not solicited by means of the offering made in reliance on Section 4(a)(6)."). This is known as the "integration doctrine."

[69] Any person can invest in an intrastate offering, in a Reg A+ or crowdfunding offering subject to investment limits, and in a Rule 506(b) offering subject to a financial sophistication standard.

confident that: (1) the Angel host is composed of accredited investors ("AIs") (whatever the term "composed" means), (2) the group's members are "interested in investing in personal capital in early-stage companies (whatever the terms "interested" and "personal capital" mean), (3) the members "hold regular meetings" (whatever "regular" means, including whether "hold" means "attended"), (4) the group has "defined processes and procedures for making investment decisions" (whatever any of that means, including whether the investment decisions reflect the group's pooling of funds), and (5) the group is not "associated with a broker, a dealer, or an investment adviser" (including whether any member may be employed by such a financial services firm and whether, for example, the group may be led by the head of a bank trust officer where all members are the trust officer's clients).

The Angel host will become, itself, a kind of regulated entity that will be at risk of aiding and abetting an illegally unregistered offer of securities if it does not satisfy the definition of "angel investor group." Will the SEC issue guidance on what are sufficiently "defined processes and procedures for making investment decisions"? Or, so soon after creating a separate set of AI verification procedures for Rule 506(c) offerings, will the SEC establish a *another* set of AI verification procedures for Angels? Will the SEC create procedures under which issuers can reasonably verify an Angel's verification procedures? Or its processes and procedures for investment decisions? Or the regularity of its meetings? Or each member's non-affiliation with a broker, dealer or investment adviser? I appreciate the heavenly power of Angels, but do they really want to go there?

Strictly as a matter of practicable compliance, the exercise of defining "angel investor group" is not reasonably worth the confusion doing so will cause. Congress should consider whether, if an angel investor group wants to host a Shark Tank, there is any reason why the group would be unable to find a government entity or instrumentality, post-secondary education institution, or nonprofit. At least all of these terms should be relatively easy to interpret, and hosts should relatively easy to find in virtually any community. Every town of reasonable size has a Chamber of Commerce branch. Every city of reasonable size has a community college branch. Under current SEC positions, presentations could be live-streamed, thereby making them easily accessible to the planet. The Act authorizes the SEC to approve more Shark Tank hosts, and it is not clear on what principled basis the agency could deny a wide swath of organizations admission to this club. It is not a good sign for efficient capital formation when simplistic, populist notions of investing "angels" infest the innards of complex administrative rulemaking.

Rule 506(c) already permits general solicitations and advertising in (public) private offerings. The only real difference the HALOS Act makes is that up to 35 non-accredited investors (the attending college students[70]) can buy stock at a de facto public presentation and issuers can be more

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[70] One member of Congress suggested that the requirement that such investors be sophisticated would prevent college students from investing. *See* House Congressional Record at H261 (Jan. 10, 2017). This is incorrect. There is no, and never has been any, practicable way to enforce this Rule 506 requirement. I am not aware of any enforcement action or private claim *ever* having been brought alleging that a non-accredited investor was not adequately sophisticated. I note that the JOBS Act required that the sophistication of investors be established. *See* JOBS Act Section 302(b). My review of funding portals suggested that this requirement is being honored most often in the breach. The Congressman also fails to note that HALOS Act presentations will undoubtedly be used to market sales under exemptions other than Rule 506. Finally, it appears that the Congressman's position is that the Securities Act's regulation of offers was *never* an appropriate approach to protecting investors.

lax about ensuring that all investors are accredited investors.[71] It is not clear why the last vestige of a quasi-private offering must be eliminated and issuers allowed to invite every one of 300 million Americans to a presentation just so issuers more easily access Angels whose status as accredited investors need not be carefully verified.

The HALOS Act represents the de facto repeal of offering regulation. The question is no longer what communications are permitted without triggering public offering rules. The Act permits public notices that specifically advertise a forum as a securities offering pitch (with only references to a "specific offering of security by" an issuer being prohibited).[72] The Act purports to require that "no specific information regarding an offering of securities by the issuer [be] communicated or distributed by or on behalf of the issuer," and then creates an exception that covers all of the essential specific information that an issuer would want to communicate regarding its offering.[73] The question has become what communications are *not* permitted, as that category has become so narrow as to be more easily defined. The answer is that any communication is permitted to any audience anywhere is the U.S. as long as it is "hosted" by a listed entity.

The HALOS Act is a de facto repeal of Section 5 of the Securities Act, the heart of 85 years of U.S. securities regulation. Admittedly, the HALOS Act rides a horse that probably has long since left the barn, as discussed above, and there is probably no going back. The more practical question is whether Congress will let that horse continue to run wild or establish a new model for promoting fair, efficient markets. Rather than repeatedly asking the SEC to adopt incoherent rules, Congress should, instead, eliminate the regulation of offers and replace it with rules that ensure that, in a world in which all offers are, in effect, allowed to be public, all offering information must be made public.

Congress has created a regulatory regime for unregistered offerings that distinctly favors accredited investors at the expense of retail investors. A $1 million public crowdfunding offering and a $50 million Reg A offering must be accompanied by publicly available filings, while Reg D issuers are allowed to keep their offering documents secret while making public investor presentations. Crowdfunding and Reg A offerings must announce their offerings, while Reg D issuers are permitted to keep them secret. Although Reg D issuers are ostensibly required to file minimal information on Form D, many (if not most) ignore that requirement.[74] The SEC has blithely observed such noncompliance in discussing Reg D offerings but expressed no interest in

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[71] The "more lax" reference here is to the purported difference between the accredited investor requirements under Rules 506(b) and (c). Congress required that 506(c) issuers take reasonable steps to verify" AI status "using methods as determined by the Commission." Prior to the JOBS Act, it was understood that issuers had to take reasonable steps to verify AI status under old Rule 506, but the necessary implication of new Rule 506(c) is that the determination of AI status under the old rule is subject to a lower standard.

[72] *See* HALOS Act Section 3(a)(B).

[73] *See* HALOS Act Section 3(a)(D) (permitting distribution of information including that the issuer will be offering securities, the type and amount of securities to be offered, the amount of securities already spoken for (i.e., "get your order in now, before we run out"), and the intended use of the proceeds).

[74] As discussed below, Congress has tilted the regulation of registered offerings against retail investors as well. This follows Congress's 1996 de facto prohibition against retail investors bringing state securities law claims while leaving that option available to large investors.

doing anything about it. If all offerings are permitted to be public, all public offering information provided to investors should be publicly available.[75]

IV. Encouraging Public Offerings Act of 2018

The Encouraging Public Offerings Act of 2018 ("Confidential Filings Act") would expand two EGC exemptions to cover all filers. Currently, the JOBS Act's roadshow exemption permits EGCs to make private presentations to qualified institutional buyers ("QIBs") and institutional accredited investors ("IAIs") before and after filing a registration statement. The JOBS Act's confidential filing exemption permits EGCs to file a confidential draft registration statement before their IPO. The Act would extend both of these exemptions to all filers. The JOBS Act provided that an EGC must file its at least 21 days before its IPO; the Fast Act reduced that number to 15.

These exemptions exacerbate the incoherent erosion of the distinction between registered and unregistered offerings and further disadvantage of retail investors vis-a-vis large investors. What makes registered offerings different is that communications do not occur in an information vacuum. During the quiet period before a registration statement is filed, no offering-related information may be disseminated. This ensures that when information is disseminated, it is against the disciplining backdrop of a filed, publicly available registration statement. Every other communication, public or private, is made with an eye to that filed document. And every investor, large and small alike, has access to the same filed registration statement as of the issuer's first public marketing of its offering.

The EGC exemption destroyed the key elements of this model. It permits issuers to make unregulated presentations without the disciplining effect of a filed registration statement as context, with a filed registration statement becoming available only 21 days prior to an EGC's IPO.[76] This model facilitates the communication of fraudulent or inaccurate information prior to the filing of a registration statement, provides large investors with a distinct informational advantage over retail investors, and provides inadequate time for investors to evaluate an EGCs registration statement.

The company discussed above, aTyr Pharma, illustrates how the confidential filing process can be abused. The company filed its first draft registration statement on December 22, 2014, and continued to file undisclosed amendments for more than 4 months before filing a public registration statement – only one month before its IPO. Prior to that filing, the SEC had objected to aTry's representations in confidential filings regarding the valuation of its stock, but this issue was still unresolved as of the first public filing. The SEC rejected additional disclosure initially proposed by aTyr to address the valuation issue,[77] and ***corrective disclosure was not included in its registration statement until 9 days before the IPO***.[78] The SEC also allowed aTyr to disclose its expected offering price range to the SEC staff 23

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[75] *See SEC's Power to Revive IPO Market*, *supra* ("In the UK, all private companies are forced to publish accounts.").
[76] The JOBS Act actually required that the registration statement be filed at least 21 days prior to the issuer's first roadshow. However, the SEC interpreted test-the-waters presentations not to be communications roadshows, although that is exactly what they are. It thereby amended the JOBS Act to permit the initial filing of a public registration statement a mere 21 days prior to the issuer's IPO.

[77] Letter from Maggie Wong, Goodwin Procter LLP, to SEC (Apr. 17, 2015) ("April 17 Letter") *available at* https://www.sec.gov/Archives/edgar/data/1339970/000119312515136534/filename1.htm

[78] aTyr Pharma Prospectus (Apr. 27, 2015) ("April 27 Prospectus") *available at* https://www.sec.gov/Archives/edgar/data/1339970/000119312515148013/d819057ds1a.htm. A redlined comparison of the originally filed section of the prospectus to the amended version is provided at Appendix A to this testimony.

days prior to the IPO[79] while still continuing to withhold that information from an amended registration statement filed 9 days prior to the IPO.[80] Thus, while retail investors had 9 days to evaluate aTyr's final amended prospectus, QIBs and IAIs had likely been receiving presentations on aTyr for weeks, if not months. Even those large investors had only 9 days to compare the information in the final amended prospectus to information they had previously received.

The Facebook IPO illustrates how retail investors are routinely disadvantaged by discriminatory treatment and the lack of fair access to information. Facebook amended its registration statement just 9 days before its IPO to include adverse information not previously disclosed.[81] While investment bankers cut their earnings forecasts[82] and reportedly communicated the new information to their large clients, retail clients were left in the dark.[83] Facebook's stock price crashed after the offering, which led to the filing of more than 40 lawsuits.

The Confidential Filings Act codifies[84] retail investors' informational disadvantage by increasing the number of issuers who may provide information to large investors when no registration statement has been made available to retail investors. The aTyr and Facebook IPOs make it clear that the SEC is quite willing to grant effectiveness even after material new information has been added to a registration statement only nine days before an IPO, perhaps even the day before an IPO. The Act engenders a policy of discrimination against and disadvantaging of retail investors that directly contradicts the core goal of registered offering regulation: ensuring access to, and the integrity of, information about public offerings and public companies.

V. Consumer Financial Choice and Capital Markets Protection Act of 2017

The Consumer Financial Choice and Capital Markets Protection Act of 2017 ("MMF Act") would permit money market funds ("MMFs") to maintain a stable net asset value of $1.00 per share and exempt such funds from imposing the liquidity fee imposed by Rule 2a-7 under the Investment Company Act. This part of the Act is intended the reverse the effect of amendments to Rule 2a-7 that the SEC adopted in response the Financial Crisis. The Act also prohibits such funds from

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[79] *See* April 17 Letter, *supra.*

[80] *See* April 27 Prospectus, *supra.* The expected range was never disclosed to the public.

[81] Steve Schaefer, *Morgan Stanley Cut Facebook Outlook Just Before IPO*, Forbes (May 22, 2012) ("a May 9 updated SEC filing that indicated the social network has seen more users migrate to mobile devices, a channel which has proven difficult to monetize to date") *available at* https://www.forbes.com/sites/steveschaefer/2012/05/22/report-morgan-stanley-cut-facebook-estimates-just-before-ipo/#4847e9b5554c. The Facebook IPO occurred on May 18.

[82] *Id.*

[83] Alistair Barr, *Morgan Stanley Cut Facebook Estimates Just Before IPO*, Reuters (May 22, 2012) ("Institutions and major clients generally enjoy quick access to investment bank research, while retail clients in many cases only get it later. It is unclear whether Morgan Stanley only told its top clients about the revised view or spread the word more broadly. The company declined to comment when asked who was told about the research.") *available at* https://www.reuters.com/article/us-facebook-forecasts/insight-morgan-stanley-cut-facebook-estimates-just-before-ipo-idUSBRE84L06920120522. Morgan Stanley subsequently was sued in connection with the Facebook IPO and settled for $5 million.

[84] The SEC previously extended confidential filing privileges to all issuers.

directly receiving federal assistance, such as the programs implemented by banking regulators in the wake of the Financial Crisis, as discussed further below.

I testified before Congress in opposition to money market fund reforms before they were adopted by the SEC.[85] My views have not changed, but circumstances have. Dozens of money market funds have closed, hundreds of billions of dollars of credit that had been extended to businesses have been diverted to the U.S. government, and institutional investors looking to find a short-term home for their cash have been forced to reevaluate their longstanding preference for money market funds.

A 2017 Fed study found that the rules resulted in a massive shift of assets from prime and municipal bond money market funds to government funds, with an increasing share of the latter going into agency debt.[86] From January 2015 to February 2017, assets in prime/muni funds declined \$1,315 billion (-65%) and assets in government funds rose by \$1,191 billion (115%).[87] The following chart from that study illustrates this transformational shift.

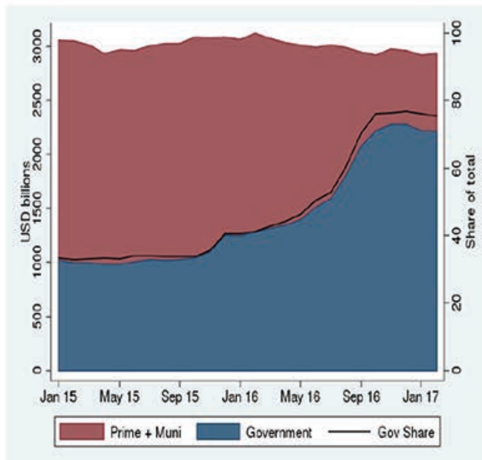
Figure 1: MMF Total Net Assets by Fund Category: Government vs. Prime & Muni.
Solid black line: share of government MMFs in percentages (right y-axis).[88]

[85] Hearing before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (June 24, 2011).

[86] *See* Marco Cipriano and Gabriele La Spada, Investors' Appetite for Money-Like Assets: The Money Market Fund Industry after the 2014 Regulatory Reform, Staff Report No. 816 (June 2017; revised June 2018) ("Fed MMF Report") *available at* https://ssrn.com/abstract=2989552.

[87] *Id.* at 5.

[88] Fed MMF Report, *supra*, at 7.



However, since 2017 this shift may have run its course. From March 2017 through April 2018, prime funds government money market assets have increased from 2,210 to 2,284 billion (13%) and prime fund assets have increased from $587 to $685 billion (17%).[89] Nonetheless, the MMF rules had a marked effect on the allocation of capital (notably one of reallocating a substantial amount of capital from private enterprise to federal government funding) and billions of dollars in lost income to investors.[90] Rising interest rates may lead to greater prime MMF gains in the future at the expense of both government funds, bank deposits and bank savings accounts, but also to substantially higher foregone income to investors.

The distortion in the market for short-term cash investments is, of course, mirrored by a distortion in the market for short-term debt. The prime-to-government debt shift has substantially reduced the role of MMFs in providing businesses with access to short-term borrowing.[91] It is ironic that, in light of the MMF rules' disruption to short-term funding markets, that Chairman

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[89] Money Market Fund Statistics, U.S. Securities and Exchange Commission (Mar. 16, 2017 & May 17, 2018). These findings are generally consistent with Chairman Clayton's October 5, 2017, letter to House Subcommittee on Markets, Securities, and Investment Ranking Member Maloney (see page 2) ("2017 Letter").

[90] For example, the total would be $8.75 billion assuming a 25 basis point spread between prime and government MMF yields from 2015 through June 2018 and $1.1 trillion in assets. As interest rates rise, the losses will be substantially higher.

[91] While there is no question that municipal bond assets in MMFs have decreased dramatically, I am not persuaded that the MMF reforms have had long-term adverse consequences in the municipal bond market as a whole. *See* U.S. Money Market Reform: Assessing the Impact, Blackrock (June 2018); Money Market Reform and Municipal Issuers, Vanguard (December 2017).

Clayton has expressed concern that permitting floating NAV MMFs "could be disruptive to the short-term funding markets."[92]

The counterargument that the MMF rules are needed to reduce systemic risk has never had a sound factual basis. Since the inception of modern money market funds, more than 3,000 banks have failed, often with disastrous consequences for depositors and other bank creditors and huge bills for taxpayers. In contrast, only two money market funds have failed. One was a very small institutional MMF that broke a dollar in the 1980s. The Reserve Fund's failure triggered a mass exodus from MMFs that posed a systemic threat, but, unlike thousands of bank failures, these near-MMF failures resulted in *zero losses* to taxpayers and non-Reserve Fund shareholders. Rather, the U.S. government enjoyed a billion-dollar windfall in the form of insurance premiums for coverage on which not one claim was ever made.

Notwithstanding such adverse effects, I have four primary concerns regarding the bill that lead me to recommend against its enactment. First, I am not aware of there having been a thorough empirical analysis of the likely effect of the MMF Act. Just as the original rules were adopted with an inadequate understanding of their effect, Congress should not rush turn back the clock without know the effect of doing so. Instead, I recommend that Congress instruct the SEC to conduct such an analysis. I disagree Chairman Clayton view that "it's too early to say we're wrong." I have no doubt that the SEC *was* wrong, but now that circumstances have changed, I am not certain that reverting to the old system would be right.

Second, I do not have faith in the SEC's ability to manage money market fund risk. In January 2008, I drafted a petition to the SEC asking it to take steps to address what I viewed as a growing risk that a money market fund would break a dollar and specifically cited the risks created by the SEC's longstanding policy of granting last-minute, ad hoc, verbal exemptive relief to address the hundreds of prior instances in which a money market fund had flirted with failure.[93] In response to the petition, the SEC did nothing and, unfortunately, my prediction proved prescient. The SEC failed to take action when the risks presented by the Reserve Fund became very apparent well before it failed, and the SEC's fumbling of the process of granting ad hoc exemptive relief contributed to the Fund's failure (and helped its executives subsequently escape liability).

Third, I am concerned that banking regulators would seize upon another money market fund failure (albeit highly unlikely) as an excuse to impose new regulations on all funds that could cripple America's mutual fund sector. Our mutual fund industry is one of the country's crown jewels, boasting some of the world's greatest businesses. They provide Americans with a low cost access to diversified portfolios of securities that have created enormous wealth for investors and funding for our capital markets. However, banking regulators have demonstrated that they do not

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[92] 2017 Letter, *supra* , at 2.

[93] Petition from Fund Democracy, Consumer Federation of America, National Association of Personal Financial Planners, Financial Planning Association, AFL-CIO and Consumer Action to SEC (Jan. 16, 2008). The petition also asked the SEC to require frequent disclosure of money market portfolios, a measure it ultimately adopted *after the Financial Crisis.*

understand that this success is attributable to managed risk-taking,[94] preferring instead the model of socialization of risk and government subsidies that lie at the heart of the banking industry and that became, as a result of the Dodd-Frank Act, an overriding guiding principle in America's financial regulatory policy. Banking regulators' inability to recognized much less embrace risk-taking as a critical and necessary foundation of a capitalist democracy is the result of our Balkanized regulatory structure, which continues to put the U.S. at a significant disadvantage to other modern economies. Unfortunately, Congress has shown little interest in addressing this foundational weakness in our financial system. The threat of a repeat of banking regulators' partly turf-driven overreaction to the Reserve Fund failure therefore continues to be very real. It is not clear that this risk is worth taking.

Finally, Congress has stripped banking regulators of powers necessary for them to take appropriate emergency action in the event of another severe liquidity event.[95] Section 1101 of the Dodd-Frank Act severely restricted banking regulators' authority under Section 13(3) of the Federal Reserve Act to extend credit to non-banking institutions, and legislation has been proposed that would impose further restrictions.[96] The MMF Act would broadly prohibit funds that rely on it from receiving any federal assistance. For all of banking regulators' post-crisis excesses, their mid-crisis management was essential to surviving the Financial Crisis. Their actions froze the run on money market funds, stabilized the industry, and actually generated substantial profits for the government while costing taxpayers nothing.[97] It is easy to forget that what might in peaceful times appear to be bureaucratic overreach may be the difference between preventing the collapse of our financial system and saving it from disaster. While it may have been prudent for Ulysses to lash himself to the mast under the circumstances, it would not have made sense to do so when the ship was headed for the rocks. With Congress having significantly hamstrung our ability to mitigate the effects of a future money market fund failure, and the MMF Act's broad prohibition against federal assistance, and considering the other factors cited above, I cannot support its rush to re-create that risk.

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[94] This is particularly true with respect to money market funds. *See generally* Melanie Fein, Shooting the Messenger: The Fed and Money Market Funds (2012). Banking regulators analysis of systemic risk posed by Metropolitan Life also showed an inadequate understanding of insurance.

[95] At the time of the Financial Crisis, the Fed has authority to extend credit to nonbanking institutions under Section 13(3) of the Federal Reserve Act. In connection with the money market fund crisis, it relied on Section 13(3) to establish the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF") and the Commercial Paper Funding Facility (CPFF"). *See* Marc Labonte, Federal Reserve: Emergency Lending, Congressional Research Service at 26 – 27 (January 6, 2011)("CRS Report"). Section 1101 severely restricted the Fed's authority under Section 13(3). *See id.* at 10 – 11 (describing restrictions); *see generally Alexander Mehra, Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis*, 13 U. Pa. J. Bus. L. 221 (2010); Eric Posner, What Legal Authority Does the Fed Need During a Liquidity Crisis? 101 Minn. L. Rev. 1529, 1532 (2017) ("Unfortunately, in the Dodd-Frank Act, Congress moved in the opposite direction, weakening rather than strengthening [the Fed's] LLR ["Lender of Last Resort"]" function). Ironically, the Fed blamed limitations on its legal authority for not bailing out Lehman Bros., and it was Lehman debt that caused the Reserve Fund to break a dollar.

[96] *See, e.g.*, H.R. 4302 (2017).

[97] The money market insurance program generated $1 billion in premiums and no claims, the AMLF "experienced no losses and earned income of $0.5 billion over the life of the program," and the CPFF "earned income of $6.1 billion over the life of the program and suffered no losses." CRS Report, *supra*, at 26 – 27.

PREPARED STATEMENT OF CHRISTOPHER H. DANIEL

CHIEF INVESTMENT OFFICER, CITY OF ALBUQUERQUE, NEW MEXICO, ON BEHALF OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION

JUNE 26, 2018

Chairman Crapo, Ranking Member Brown, and distinguished Members of the Committee on Banking, Housing, and Urban Affairs, thank you for holding today's hearing on legislative proposals to increase access to capital. My name is Chris Daniel and I serve as the Chief Investment Officer for the City of Albuquerque, New Mexico. My remarks here today are in my capacity as a representative of the membership of the Government Finance Officers Association (GFOA). GFOA represents nearly 20,000 public finance officers from State and local governments, schools, and special districts throughout the United States.

GFOA is dedicated to the professional management of governmental financial resources by advancing fiscal strategies, policies and practices for the public benefit, including issues related to issuing tax exempt bonds and investing public funds. We appreciate this Committee's continued support for efforts to strengthen the municipal bond market, especially the recent enactment of legislation designating municipal securities as high-quality liquid assets. Such actions help States, local governments and other governmental entities maintain access to low-cost capital, which is vital to infrastructure investment across the United States and contributes to a healthy and vibrant economy. On behalf of the GFOA and its members, I appreciate the opportunity to provide comments at this hearing in support of S. 1117, the Consumer Financial Choice and Capital Markets Protection Act of 2017.

This morning I will describe how money market funds have been utilized effectively to both manage liquidity for public sector investments and provide a reliable source of working capital to fund public services and finance infrastructure investment and economic development. I will also describe the impact of the U.S. Security and Exchange Commission's (SEC) change of net-asset-value (NAV) accounting methodology for money market mutual funds (MMMF) from stable to floating.

State and local governments access the capital markets and issue short term debt for a variety of reasons. This important legislation would allow State and local governments to continue this access and investor appetite for short term debt issuance without increasing costs for taxpayers or creating risks to the financial system For Governments like the City of Albuquerque, variable-rate debt has been a very low-cost method of financing as compared to issuing fixed-rate bonds. GFOA has published best practice guidance on the use of variable rate debt by Government issuers to ensure that it is used appropriately. Also, variable rate debt issued by State and local governments has historically been a reliable low risk investment type for money market fund sponsors. Money market funds themselves are key purchasers of municipal securities—historically, they have been the largest purchasers of short-term tax exempt debt. Therefore, the impact of SEC Rule 2a-7 of the Investment Company Act of 1940, as amended in 2010 and 2014, on Governments is real and it affects not only large governmental entities, but also small communities throughout the country.

Additionally, money market funds are a widely used cash management and investment tool for State and local governments. According to Federal Reserve data, State and local governments hold over $190 billion of assets in money market funds.[1]

While we have supported and continue to support initiatives that both strengthen money market funds and ensure that investors are investing in high-quality securities, we applaud Senators Toomey, Manchin, Rounds, and Menendez for introducing legislation which focuses on addressing the unintended consequences of the SEC's 2014 Amendments to Rule 2a-7 that require institutional, nongovernment MMFs to price their shares at a floating net asset value (NAV), by allowing those funds to return to a fixed NAV.

The original objectives of the floating NAV rule were to protect investors in money market funds by preventing runs that hamper access to short-term capital, shield taxpayers from future financial bailouts, and promote general market stability. Those objectives were effectively addressed in the 2010 Amendments to Rule 2a-7. GFOA supported those amendments which dramatically increased the credit quality of the assets held in MMFs, required money market funds to have a minimum percentage of their assets in highly liquid securities so that those assets can be readily converted to cash to pay redeeming shareholders, and increased transparency by re-

[1] See *https://www.federalreserve.gov/releases/z1/20180607/z1.pdf*, p. 84.

quiring funds to regularly calculate their portfolios' per-share values at market prices.

Despite the success of the 2010 reforms, the SEC adopted additional amendments to Rule 2a-7 in July 2014. Among other things, those amendments require institutional prime- and tax-exempt funds to use a floating NAV. The SEC's reasoning for the 2014 Amendments was that a floating NAV would provide investors with a more frequent and accurate assessment of the value of a fund's assets. Under previous rules, institutional prime- and tax-exempt MMFs were allowed to round their share price to $1.00, so long as the actual value of a share does not fall below $0.9950 ("known as breaking the buck"). The SEC's change from fixed to floating was predicated on the belief that investor awareness of the actual value of the fund's assets will make investors less likely to redeem shares in times of economic distress.

Throughout the rulemaking process, GFOA and public finance officers throughout the country submitted analysis showing that a floating NAV would do little to deter heavy redemptions during a financial crisis but would, instead, impose substantial costs on State and local governments. That is exactly what has come to fruition.

The 2014 Amendments have dramatically shrunk an important market for municipal debt. Between January 2016 and April 2018, tax exempt MMFs assets under management fell by nearly 50 percent, from $254 billion to $135 billion,[2] as MMF investors, including Government investors, preferred or were required to hold stable-NAV Government MMF's comprised of Treasury and/or U.S. Agency securities. The lack of investor appetite for floating-NAV tax-exempt MMMF's resulted in municipalities issuing variable rate demand bonds seeing their borrowing costs nearly double the Federal Reserve's rate increases over the same period. Many State and local governments determined that issuing variable rate debt to MMFs was excessively costly, and opted to issue higher cost fixed-rate bonds. These increased costs are shouldered by taxpayers and ratepayers.

In addition to the impact that the 2014 Amendments had on Governments finding investors for their short-term debt issuances, there are also implications for the investments that State and local governments use to protect public funds. Many Governments have specific State or local statutes and policies that require them to invest in financial products with a stable NAV. The policy reason for this is to ensure that public funds are appropriately safeguarded.

It is important to emphasize that MMFs with a stable NAV, particular prime MMFs, are required to meet the highest liquidity and credit quality standards, which is why they are a commonly used vehicle by State and local governments for managing operating cash. This important legislation would lift an unnecessary obstacle that has steered State and local entities into very low yielding U.S. Government backed funds or other alternatives from what was already one of the safest sources for earning market returns on the management of cash, short of FDIC-insured bank accounts.

By allowing all MMFs—prime, tax-exempt and Government funds accessible to both retail and institutional investors—to offer a stable NAV, S. 1117 would allow State and local governments to once again utilize suitable investments as defined by State and local elected officials, rather than by the SEC. The disruptions to the short-term capital markets caused by the SEC's floating-NAV rule are real and irrevocable short of restoring the stable NAV. The legislation fixes that problem, and does so without undermining the other important reforms that have made MMFs resilient to the kind of market disruptions that occurred in 2008. GFOA is working with a coalition of stakeholders to advance S. 1117 and we have submitted our most recent letter of support for the record. Thank you again for considering this important legislation. We look forward to working with you and supporting your efforts to help State and local governments on this and other regulatory and financial matters of mutual interest.

[2] *https://www.sec.gov/divisions/investment/mmf-statistics/mmf-statistics-2018-04.pdf*, p. 4.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM RAYMOND J. KEATING

Q.1. In response to questions on the Helping Angels Lead Our Startups (HALOS) Act, S. 588, you stated that, "[w]hat we are talking about here is going to angel investors. I mean, that is in the title of the legislation. So I think when we are talking about understanding who we are going to and what the purpose of these demos are, I think it makes—I think the legislation makes perfect sense."

Please explain how the limitation you described, "[w]hat we are talking about here is going to angel investors", is required under the bill. In addition, please explain if you believe there is any stated requirement that the event sponsors outlined in section 3(a)(2)(A) of the bill must verify any information with respect to an attendee at an event that would be covered by the bill.

A.1. This legislation would revise Regulation D, as noted in the CRS summary of S. 588, as pertaining "to events with specified kinds of sponsors, including 'angel investor groups' unconnected to broker-dealers or investment advisers," in cases where, in part, "the sponsor does not provide investment recommendation or advice to attendees, engage in investment negotiations with attendees, charge certain fees, or receive certain compensation." In the end, it is critical to keep in mind that these events, often referred to as "demo days," are geared toward the "accredited investors" who can purchase securities under the Section 506 exemption. However, at the same time, these events allow entrepreneurs and startups to interact with accredited investors, such as angel investors, while not soliciting investors to purchase an equity stake. Given these straightforward cases and limitations, this legislation lifts unwarranted burdens and costs placed on entrepreneurs and startups regarding "demo days."

Q.2. The Small Business Audit Correction Act, S. 3004, would allow certain brokers or dealers defined under the bill to use auditors that are exempt from Public Company Accounting Oversight Board registration and supervision.

How many brokers or dealers do you believe would be covered by the definition in the bill?

Does that definition in the bill capture brokers or dealers in one or more of the following categories: active high-frequency trading or principal trading firms, sophisticated market-maker firms, private placement brokers, dealers in the to-be-announced (TBA) for mortgage-backed securities market, and alternative trading system routing brokers, in addition to retail customer facing brokers or dealers?

A.2. As noted in my testimony, "This legislation would redress the Dodd–Frank requirement that all investment brokers and dealers, no matter their size, must hire a Public Company Accounting Oversight Board (PCAOB)-registered audit firm to conduct audits that use complex guidelines designed for larger, public companies." S. 3004 would provide relief to small investment firms overburdened by this requirement. As for the questions about coverage and definition, the Financial Services Institute in its letter of support for S. 3004 noted the following points:

> "Currently, the Dodd–Frank Act requires all investment brokers and dealers, irrespective of size, to hire a PCAOB-registered audit firm to conduct audits using significantly more complex guidelines designed for larger, public companies. We believe this legislation will provide much-needed regulatory relief to small broker-dealers by exempting them from the most onerous audit requirements."
>
> "The broker-dealer community in the financial services industry consists of large companies, midsized firms, and small businesses. As of November 2017, the small business community consisted of 3,425 firms all employing 150 registered reps or fewer. Ten years ago, there were approximately 1,000 more of these small businesses in our industry than there are today, but the crush of regulatory burdens, including the PCAOB-registered audit firm requirement, has led to their demise. The remaining small firms are feeling this impact especially hard as fees rise due to the smaller pool of audit firms. The impact is felt throughout the country as these Main Street businesses struggle to remain viable."

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE FROM RAYMOND J. KEATING

Q.1. As policymakers how should we strike the right balance between encouraging firms to go public and improving the private capital markets?

Are the private capital markets currently high-functioning? If not, where are the biggest potential areas for improvement?

I'm concerned about the increasingly uneven geographic distribution of growth. As the Economic Innovation Group has found, economic growth is largely clustered in the most prosperous areas, instead of evenly distributed across areas like the Great Plains and the Midwest. Would increasing access to equity and crowdfunded debt improve the geographic distribution of new firms?

When do new and smaller firms tend to rely upon access to equity or crowdfunded debt instead of a traditional bank loan? For example, some have suggested that technology-based firms rely more upon equity while main street companies like restaurants more rely upon bank loans. What are the biggest hurdles new and smaller firms have—regulatorily or otherwise—in accessing equity and crowdfunded debt?

Is there currently sufficient clarity about the conditions under which an offering by a small business issuer would qualify as a "transactions by an issuer not involving any public offering" under Section 4(a)(2) of the Securities Act? Are small businesses able to acquire such clarity without paying a meaningful amount in legal fees?

Representative Emmer's bill, H.R. 2201, the Micro-Offering Safe Harbor Act would "exempt certain micro-offerings from: (1) State regulation of securities offerings, and (2) Federal prohibitions related to interstate solicitation." Such offerings could be worth up to $500,000, have 35 participants, and involve and instance where the "purchaser has a substantive preexisting relationship with the issuer." How would you evaluate this legislation? If you have concerns with this legislation, how would you ideally address them?

How viable is conducting an offering under the SEC's Regulation Crowdfunding, particularly for new and smaller businesses? What about for businesses that are not located in the top five largest cities? What about for smaller offering sizes? If smaller offering sizes tend to be less viable, how large must an offering be to be viable?

Would there be merit to increasing the offering limit for Regulation Crowdfunding issuers, from $1 million? Why or why not? If so, what should the limit be? For example, the 2017 SEC Government-Business Forum on Small Business Capital Formation recommended raising the limit to $5 million.

A.1. In the following, I hope to at least provide a few thoughts of value on your various questions.

First, regarding how should "strike the right balance between encouraging firms to go public and improving the private capital markets," in the end, it's not an either/or. Nor should it be that policymakers "encourage" firms to go public. Instead, policymaking should be focused on establishing the best possible policy climates for public and private capital markets to flourish, and thereby allowing entrepreneurs and investors to make decisions about, for example, staying private or going public, based on economic, business, industry and market assessment, rather than according to costs imposed by Government.

Second, I think it is fair to say that the U.S. has among the most high-functioning private capital markets across the global economy. Impediments largely come from outdated or intrusive governmental policies, including unnecessary and costly regulations, such as via various aspects of Sarbanes–Oxley and Dodd–Frank, and areas of high and/or multiple layers of taxation. On July 17, the U.S. House passed the JOBS and Investor Confidence Act (JOBS Act 3.0), which is a solid package of reforms to modernize some securities laws, and improve capital access and capital formation, particularly for entrepreneurs and small businesses. The biggest potential areas of improvement at this point are areas where there is a bipartisan consensus to make changes, and those reforms and solutions are represented within JOBS Act 3.0. Hopefully, the Senate will also act, and then we can build on JOBS Act 3.0 improvements from there.

Third, the geographic challenges in terms of growth are quite troubling. A variety of factors can come into play, including shifts in views on entrepreneurship; State and local government costs, impediments and obstacles to risk taking (please see SBE Council's Small Business Policy Index and Small Business Tax Index, which break out dozens of measures and rankings by State); access to markets; as well as access to capital issues, including the decline in small community banking, as noted in my testimony. I would very much agree that increasing access to crowdfunded equity and debt would improve the geographic distribution of new firms, though understanding, again, that other factors also are in play. These other factors include access to broadband and migration patterns. SBE Council is working on many fronts—including education and boosting entrepreneurship among the general population, as new business formation remains weak—to improve opportunities and appeal within rural areas that have been "left behind" by the recovery.

Fourth, I think, in general, it is a fair assessment that technology firms tend to rely on equity financing more so than do certain Main Street businesses like restaurants, and that largely would be due to the fact that equity investors generally have a better chance to make a notable return in tech, justifying the risk involved, as opposed to restaurants and similar business with traditionally tighter margins and bank loans (or debt-based crowdfunding) tending to make a better fit. As for the development of crowdfunding equity and debt markets, again, these are clear plusses for firms seeking either equity or debt financing. In fact, a review of the firms that have used Title III equity crowdfunding to date shows that firms of all types are using Regulation Crowdfunding, and doing so successfully.

Because it took the SEC 4 years to write the rules around Title III crowdfunding, this approach to raising capital is still fairly new. However, early adopters across industries have been successful in raising funds. For example, according to Crowdfund Capital Advisors, 715 firms have successfully raised a combined $137,565,606 from 133,006 investors. The average amount raised is $238,534. That might not sound like much compared to the millions of dollars that early stage companies often raise, but for the small businesses that need this capital to grow, it is very important indeed. The top industries that have successfully tapped into regulated crowdfunding include: applications software (132 firms), beverages (81 firms), entertainment (70 firms), personal services (67), consumer products (60), computer hardware (50), retail (50), restaurants (49 firms), autos (37), baking (31), and advertising (28). There are more regulatory complexities involved with equity vs. debt-based crowdfunding. As noted below, there are various reforms that will help more entrepreneurs and startups leverage crowdfunding if these costs are lowered, which would improve the appeal of equity crowdfunding as significant time and resources by the issuer is put into a campaign and they cannot access those funds if the target amount or goal is not reached. One of the biggest hurdles at this point is education—that is educating both small businesses and investors about this opportunity. In this regard, SBE Council has been at the forefront of small business education. For example, we recently teamed up with SCORE to host a webinar about how to raise capital via regulated crowdfunding and more than 2,000 individuals registered for the event. So there is great interest, across industries and in every corner of the U.S., and SBE Council believes that we are in the very early stages of what will become a mainstream method for raising capital, including in rural areas where new Opportunity Zones will hopefully play a big role in mobilizing capital to these areas and crowdfunding can be used as an efficient conduit for doing so.

SBE Council supports H.R. 2201, the Micro Offering Safe Harbor Act: "H.R. 2201 would exempt from registration requirements with the Securities and Exchange Commission (SEC) offerings made only to the entrepreneur's friends and family, to less than 35 purchasers, and when $500,000 or less is raised. The offering would be exempt from State registration and qualification rules, thus reducing costs and complexity. H.R. 2201 would appropriately scale SEC rules and regulatory compliance for our Nation's small businesses, which in turn will provide another practical option for entrepreneurs to raise the capital they need to start or grow their firms." At this point we do not have any major suggestions regarding H.R. 2201, except perhaps to strengthen transparency via simple reporting and compliance.

Sixth, and finally, again as detailed in my written testimony: "[R]egulated (Title III) crowdfunding is beginning to gain traction in the marketplace. Refining some of rules would help many entrepreneurs tap into this promising funding option. Some of the reforms supported by SBE Council include raising the amount that can be raised (which is currently $1 million), allowing issuers to 'test the waters,' allowing for special (or single) purpose vehicles, providing simplified rules for advertising, legal clarity for platforms, and removing the caps for accredited investors, among other changes." SBE Council fully supports lifting the amount of capital that can be raised. The current limit, $1.07 million in a 12-month period, is restricting the use of regulated crowdfunding (Title III) although there has been the successful use of parallel offerings via Title III and Title II crowdfunding. SBE Council is currently working with all the major crowdfunding platforms on this very issue and we feel that the limit should be raised to $20 million. To date, there has been no fraud associated with regulated crowdfunding and the $20 million limit would fill a big void in the marketplace for small businesses and promising firms that require larger amounts of financing to scale or for expansion projects.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR COTTON FROM RAYMOND J. KEATING

Q.1. Regarding S. 3004, one possible objection is that, in the 5 years since noncustodial broker-dealers have been required to use a PCAOB-registered auditor, the PCAOB has consistently found those audits to have high levels of "deficiencies." The deficiencies are with the expensive PCAOB auditors, not with the broker-dealers. Some feel the deficiencies are an argument in favor of S. 3004, since it illustrates the "square peg, round hole" problem of applying PCAOB audit requirements rather than the AICPA's GAAS standards that these brokers used to use. So currently these small, privately held noncustodial brokers are being forced to choose an auditor from the PCAOB's list, firms that charge much higher prices, and the end product often has deficiencies that are (perhaps) due to the type of auditing standards being applied. The audits of the noncustodial brokers may have even higher rates of deficiencies, and these broker-dealers tend to be much smaller than custodial brokers, and thus (perhaps) even less suited to the PCAOB requirements.

Are the deficiencies in these PCAOB audits evidence in favor of keeping the law as it is, or in favor of passing S. 3004? What of the fact that audits of noncustodial brokers are even higher than for custodial firms?

Attached is a letter from one of those approximately 480 PCAOB-registered firms, a firm that in theory should benefit from the status quo, but it illustrates the issue from the auditor's perspective. The link below talks about the PCAOB's 2017 report.

A.1. While circumstances and results certainly can be unique to each case, the costs and general results related to PCAOB audits of small, privately held noncustodial brokers indicate that the law and standards do not properly fit these entities. As noted in the April 2017 *Wall Street Journal* article you referenced: "The Public Company Accounting Oversight Board found deficiencies in 83 percent of the broker-dealer audits it inspected in 2016, up from 77 percent in 2015, the board said in its annual report on its broker-dealer audit-inspection program. As has been the case in the past, nearly all of the audit firms conducting the audits, 97 percent, had deficiencies in one or more of their audits, the PCAOB said. The findings don't mean that the broker-dealers themselves have any operational problems, just that the PCAOB believes that most of the audits that assessed them were flawed or inadequate." Again, as stated in my testimony, SBE Council supports S. 3004 and its focus on properly aligning regulation with the realities of small businesses.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR ROUNDS FROM RAYMOND J. KEATING

Q.1. During the Banking Committee's hearing on Legislative Proposals to Increase Access to Capital, Professor Mercer Bullard from the University of Mississippi School of Law expressed the following view on S. 1117, the Consumer Financial Choice and Capital Markets Protection Act of 2017. Could each of you please comment on Mr. Bullard's views?

> **Mr. Bullard.** Sure. That is correct that I testified against the SEC rules primarily because money market funds had demonstrated an astonishing level of safety, especially having had two break a dollar, one not even a retail fund, over about 40 years, at the same time thousands of banks failed. But I think one of the concerns Vanguard and BlackRock have and one reason they are probably opposing this is, of course, that these rules were adopted in response to the Dodd–Frank Act, which gave banking regulators, in my view, far too much authority over what I would call risk-based markets. Banking regulation and banks are designed with the socialization of risk in mind, and when you put them in charge and the SEC realizes that FSOC is controlled by banking regulators, they will bend to banking regulators' will. So I cannot even fully blame them for what happened. But it was, I think, inevitable that there would be massive dislocation and expense. That has already occurred. Since then I think that there have been mitigating effects on the municipal business, but I think that is probably a close call. But I am concerned about that BlackRock–Vanguard concern, which is if you reintroduce floating rate NAV funds, frankly Federated will roll out a lot of funds. That will be a competitive disadvantage for the large money market fund managers. They will have to go back into the business, and

then the next time a money market fund breaks, the banking regulators will have a lot less power to save the industry and, frankly, I would expect Congress to go back and end up maybe taking the same steps that dislocates the industry again.

I think the interesting point of view is we have been through this once. We do not want to go through it again. Just leave us alone.

But, you know, the free market guy in me says there is more capital that is out there looking for purchasers in a demonstrated, successful way to create essentially a cash vehicle for retail investors, and that should be an available option.

Another concern is really a specific SEC concern. One reason the Reserve Fund failed is the SEC was not monitoring the funds that had the greatest risk of failing. It also had this no-action process whereby a fund that was about to break a dollar, which had happened hundreds of times previously, was to call up an office in the SEC, and a guy picks up the phone and says, "Okay, you are fine," and because that process was fumbled by the staff, in my opinion, and because it was such an ad hoc system in the first place, that contributed to the Reserve Fund failure. It was a primary element of their defense when the founders were sued, and I think that has to be corrected.

And then, finally, I think that it is a mistake—as much as you can tell, I am probably not the biggest friend of banking regulators—to overly hamstring their Depression era authority to emergency situations, use their lending authority for nonbanks. I think that this bill would further hamstring them, and I think that is a mistake.

A.1. SBE Council has not taken a position on S. 1117, so I would be unable to answer this question—at least at this point in time.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM RAYMOND J. KEATING

Q.1. In the past year, we have had two high-profile chronic liars that defrauded investors. Elizabeth Holmes from Theranos sold a false blood testing system and raised $700 million from wealthy investors. Martin Shkreli is serving a 7-year prison sentence for lying about returns to his investors. Shkreli specialized in buying drugs, like Daraprim, a 62-year-old life-saving drug that helps newborns and people with HIV, and then raising the price from $13.50 to $750 a pill. Both Holmes and Shkreli ran private companies. As private firms, they did not have strong oversight from State regulators or from the Securities and Exchange Commission. Elizabeth Holmes' firm, Theranos, bilked investors of more than $700 million dollars. Martin Shkreli was sentenced to 7 years in prison for lying to his investors.

Of the six capital formation bills we considered which of these are going to help investors distinguish good-faith pipe dreams from fraudsters like Elizabeth Holmes and Martin Shkreli?

Which bills do you think would make it easier for fraudsters to rip off investors?

A.1. The capital formation bills under consideration during the hearing entitled "Legislative Proposals to Increase Access to Capital" were meant to redress unwarranted burdens and costs facing entrepreneurs and small businesses seeking to raise financial capital in order to grow by better serving customers, and thereby also aiding economic, income and employment growth. There is nothing in these bills that would further open the door to fraud. The bills provide commonsense relief while still protecting investors. In the end, of course, private markets and assorted laws provide various means to protect investors and consumers from fraud, and where fraud is perpetrated, lawbreakers are pursued by the proper authorities, with the expectation of being caught and prosecuted accordingly. Unfortunately, there will always be some people who attempt to defraud or rip off others. Thankfully, technology has helped to boost transparency, as well as communications between investors and the public so that schemes are uncovered and put to an end more quickly.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM MERCER E. BULLARD

Q.1. Your testimony discussed the Fostering Innovation Act, S. 2126 and raised concerns with exempting additional companies from the requirements of section 404(b) of the Sarbanes–Oxley Act (SOX).

Last week, the SEC approved its final rule on the smaller reporting company definition, which also impacts the application of SOX section 404(b).

Are you concerned that the SEC rule change expands the number of companies exempt from SOX section 404(b)? Given the rule is S. 2126 still necessary?

A.1. Response not received in time for publication.

Q.2. Does the Helping Angels Lead Our Startups (HALOS) Act, S. 588, propose any limits on the type of investors or persons that may attend a "demo day"?

In addition, please describe any requirements to evaluate attendees that would be imposed on entities that could serve as an event sponsors, as outlined in the section 3(a)(2)(A) of the bill.

A.2. Response not received in time for publication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE FROM MERCER E. BULLARD

Q.1. As policymakers, how should we strike the right balance between encouraging firms to go public and improving the private capital markets?

Are the private capital markets currently high-functioning? If not, where are the biggest potential areas for improvement?

I'm concerned about the increasingly uneven geographic distribution of growth. As the Economic Innovation Group has found, economic growth is largely clustered in the most prosperous areas, instead of evenly distributed across areas like the Great Plains and the Midwest. Would increasing access to equity and crowdfunded debt improve the geographic distribution of new firms?

When do new and smaller firms tend to rely upon access to equity or crowdfunded debt instead of a traditional bank loan? For example, some have suggested that technology-based firms rely more upon equity while main street companies like restaurants more rely upon bank loans. What are the biggest hurdles new and smaller firms have—regulatorily or otherwise—in accessing equity and crowdfunded debt?

Is there currently sufficient clarity about the conditions under which an offering by a small business issuer would qualify as a "transactions by an issuer not involving any public offering" under Section 4(a)(2) of the Securities Act? Are small businesses able to acquire such clarity without paying a meaningful amount in legal fees?

Representative Emmer's bill, H.R. 2201, the Micro Offering Safe Harbor Act would "exempt certain micro-offerings from: (1) State regulation of securities offerings, and (2) Federal prohibitions related to interstate solicitation."[1] Such offerings could be worth up to $500,000, have 35 participants, and involve and instance where the "purchaser has a substantive preexisting relationship with the issuer. . . . "[2] How would you evaluate this legislation? If you have concerns with this legislation, how would you ideally address them?

How viable is conducting an offering under the SEC's Regulation Crowdfunding, particularly for new and smaller businesses? What about for businesses that are not located in the top five largest cities? What about for smaller offering sizes? If smaller offering sizes tend to be less viable, how large must an offering be to be viable?

Would there be merit to increasing the offering limit for Regulation Crowdfunding issuers, from $1 million? Why or why not? If so, what should the limit be? For example, the 2017 SEC Government–Business Forum on Small Business Capital Formation recommended raising the limit to $5 million.

A.1. Responses not received in time for publication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR COTTON FROM MERCER E. BULLARD

Q.1. Regarding S. 3004, one possible objection is that, in the 5 years since noncustodial brokerdealers have been required to use a PCAOB-registered auditor, the PCAOB has consistently found those audits to have high levels of "deficiencies." The deficiencies are with the expensive PCAOB auditors, not with the broker-dealers. Some feel the deficiencies are an argument in favor of S. 3004, since it illustrates the "square peg, round hole" problem of applying PCAOB audit requirements rather than the AICPA's GAAS standards that these brokers used to use. So currently these small, privately held noncustodial brokers are being forced to choose an auditor from the PCAOB's list, firms that charge much higher prices, and the end product often has deficiencies that are (perhaps) due

[1] *https://www.congress.gov/bill/115th-congress/house-bill/2201*
[2] *https://www.congress.gov/bill/115th-congress/house-bill/2201*

to the type of auditing standards being applied. The audits of the noncustodial brokers may have even higher rates of deficiencies, and these broker-dealers tend to be much smaller than custodial brokers, and thus (perhaps) even less suited to the PCAOB requirements.

Are the deficiencies in these PCAOB audits evidence in favor of keeping the law as it is, or in favor of passing S. 3004? What of the fact that audits of noncustodial brokers are even higher than for custodial firms?

Attached is a letter from one of those—480 PCAOB-registered firms, a firm that in theory should benefit from the status quo, but it illustrates the issue from the auditor's perspective. The link below talks about the PCAOB's 2017 report (*https://www.wsj.com/articles/inspectors-again-find-problems-in-how-broker-dealers-are-auditedpcaob-says-1503074899*).

A.1. Response not received in time for publication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM MERCER E. BULLARD

Q.1. Do money market funds benefit the public by providing an efficient means of intermediating short-term cash investments with short-term financing needs of State and local governments and businesses?

In your testimony, you state, "[t]he counterargument that the MMF rules are needed to reduce systemic risk has never had a sound factual basis." Can you explain this statement?

In your testimony, you state, "I do not have faith in the SEC's ability to manage money market fund risk," however, you also recommend that the SEC should conduct an analysis on the impacts of the legislation before it is enacted. If you do not have faith in the SEC's ability tomanage money market fund risk, why do you believe the agency is equipped to conduct an empirical analysis of the legislation's impact?

During the hearing, in response to a question from Senator Rounds, you said, "I think one of the concerns Vanguard and BlackRock have and one reason there [sic] probably opposing this is of course, these rules were adopted in response to the Dodd–Frank Act which gave banking regulators in my view, far too much authority over what I would call risk-based markets." [1]

In fact, a memorandum written by the Investment Company Institute (ICI) states, "Although FSOC's recommendations regarding money market funds and SIFI designation do not appear to be an active threat under the Trump administration, some ICI members have raised concerns that overturning the SEC's reforms by legislation may reenergize bank regulators and financial reform activists. These members wish to avoid spurring FSOC-under a future administration to return to its examination of the industry and possibly to seek to apply ill-suited, bank-oriented measures to money market funds, other regulated funds, or fund advisors." [2]

[1] *https://plus.cq.com/doc/congressionaltranscripts-534822773*
[2] ICI Memo, January 5, 2018.

Is it your opinion that if S. 1117 is enacted, large asset managers such as Vanguard and BlackRock will be more vulnerable to designation as nonbank systemically important financial institutions by future administrations?

A.1. Responses not received in time for publication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM MERCER E. BULLARD

Q.1. In the past year, we have had two high-profile chronic liars that defrauded investors. Elizabeth Holmes from Theranos sold a false blood testing system and raised $700 million from wealthy investors. Martin Shkreli is serving a 7-year prison sentence for lying about returns to his investors. Shkreli specialized in buying drugs, like Daraprim, a 62-year-old life-saving drug that helps newborns and people with HIV, and then raising the price from $13.50 to $750 a pill. Both Holmes and Shkreli ran private companies. As private firms, they did not have strong oversight from State regulators or from the Securities and Exchange Commission. Elizabeth Holmes' firm, Theranos, bilked investors of more than $700 million dollars. Martin Shkreli was sentenced to 7 years in prison for lying to his investors.

Of the six capital formation bills we considered which of these are going to help investors distinguish good-faith pipe dreams from fraudsters like Elizabeth Holmes and Martin Shkreli?

Which bills do you think would make it easier for fraudsters to rip off investors?

Some say start up culture encourages a "fake it till you make it" hustle when pitching investors.

Do you see Elizabeth Holmes and Martin Shrkeli as indicative of the perils of this "fake it till you make it" ethos that makes investing in start-ups risky or are they just unique and terrible exceptions?

Professor Bullard, in 2012, Congress passed the JOBS Act into law. It made it easier for companies to raise capital.

Do you have any concern that these one-off bills represent a piecemeal approach that may interact with one another in unforeseen ways?

Rather than the piecemeal approach taken with these bills, might a comprehensive review of the requirements of, and interactions between, the Securities Act of 1933 and the Securities Exchange Act of 1934 be more desirable?

Professor Bullard, on May 3, the United States Court of Appeals for the Second Circuit in Manhattan overturned for the second time the conviction of Jesse C. Litvak, a former trader at Jefferies & Co., for misstating the price at which his firm had acquired residential mortgage backed securities and then resold them to investors.

The appeals court said Mr. Litvak had no duty to the firm's customers, who were all sophisticated investors, to provide truthful information. The court said that sophisticated investors should not rely on statements from traders.

In two other cases—U.S. vs. Weimert in Chicago and a case against David Demos, former managing director at Cantor Fitzgerald—financial services employees who misled investors by providing false information were not convicted because the judges found that misleading other parties about prices and terms is not criminal.

What is the impact for prosecutors when judges refuse to hold financial executives accountable for misstatements to sophisticated investors?

The Murdoch's, DeVos's, and other millionaires lost a hundred million dollars or more when they invested in Theranos. Should wealthy people follow the "buyer beware" approach when they invest in start ups? Can "sophisticated investors" be defrauded?

The accredited investor criteria was set in 1982: a million in wealth or $300,000 in couple income. It has not been increased since then. What level do you think the wealth and income level should be increased to? Do you think having a wealth and income threshold as the test is appropriate? Should there be some kind of test or access for knowledgeable experts who might have less wealth/income?

A.1. Responses not received in time for publication.

RESPONSES TO WRITTEN QUESTIONS OF THE SENATE BANKING COMMITTEE FROM CHRISTOPHER H. DANIEL

Hearing of the Committee on Banking, Housing and Urban Affairs
"Legislative Proposals to Increase Access to Capital"
June 26, 2018
Responses to Questions for the Record for
Mr. Chris Daniels, Chief Investment Officer
of the City of Albuquerque, NM on behalf of the
Government Finance Officers Association

Ranking Member Brown, thank you for the opportunity both to testify at the Senate Banking Committee's hearing on June 26, 2018 in support of S. 1117, the "Consumer Financial Choice and Capital Markets Protection Act of 2017" and to respond to your further questions for the record. The Government Finance Officers Association ("GFOA") greatly appreciates the opportunity to elaborate on the reasons why enacting S. 1117 will benefit all investors and borrowers, both in Ohio and across the county, by enabling prudent cash management and efficient, low-cost capital markets financing capacity.

In order to facilitate explanation, the responses to your questions are in a different order than asked. The questions on borrowing costs (questions 1-4 and 7) are grouped separately from those concerning investing cash (questions 5 and 6).

Increased cost of financing (Questions 1-4 and 7).

The over-arching theme behind your individual questions appears to be:

How did the SEC's 2014 amendments to Rule 2a-7 (the "2014 Amendments"), governing money market funds ("MMFs") lead to higher tax equivalent borrowing costs for municipalities and will those excess borrowing costs recede if markets achieve long term equilibrium without the remedies provided by S. 1117?

As GFOA further explains in the Q&A below, it's the basics of supply and demand operating in a rational market.

- Municipalities borrow for short-term needs, creating "supply" of short-term tax-exempt securities.
- Investors seeking tax-advantaged returns buy, that is "demand", these securities.
- The rate at which the supply of debt instruments from municipalities satisfies the investor demand is the market-clearing rate (equilibrium).
- If municipalities increase borrowing, supply increases. Given no other change rates will rise to attract more investors. Similarly, if investors lose their appetite for municipal securities, rates also rise to increase investor appetite.
- On the other hand, if investors flush with cash want to invest in municipal securities, rates will fall since there is plenty of cash to go around.

Supply, the amount of short-term debt issued by municipalities, is relatively level. For the thousands of municipalities, in the aggregate supply grows at roughly the same rate as the U.S.

economy. The specific mix of debt instruments may change over time. VRDNs[1], tax anticipation notes, TOBs and bank loans. There can be temporary seasonal trends, but over time, the aggregate levels will grow roughly in line with the economy.

The stability of the "supply" side of the equation tells us then, that over time, it's investor "demand" that will be the key determinant of municipal borrowing costs. So let's examine the demand.

Demand for municipal securities arises through three primary channels: Tax-exempt, or municipal, MMFs ("Municipal MMFs"), commercial banks, and individual investors (directly or through trusts, or other vehicles).

- Municipal MMFs are the most economically efficient, seamlessly bringing together investors and borrowers with minimal friction or transaction cost. Because the 2014 regulations created a number of operational barriers, investors fled and total Municipal MMF assets fell over 40% from $250 billion to $130 billion. This shrunk the demand side of the equation and rates rose. In fact, they increased at a pace almost double the Fed rate increases during that period on a tax equivalent basis.[2]

- Commercial banks are a reasonably efficient source of demand but costlier to the municipality. Because of the Volcker Rule (recently somewhat mitigated) underwriting costs to municipalities have increased. Because of LCR requirements, it's more expensive for banks to issue letters of credit, which back much municipal debt. Because of the Basel III leverage ratio, it costs more for banks to hold municipal loans or securities on their balance sheet. And finally, with the recent cut in corporate tax rates (almost in half), banks no longer find it cost effective to hold municipal tax advantaged securities in their portfolios. For all of these reasons, banks are an unattractive, high cost for municipal borrowers.

- Individual investors find the greatest benefit in the tax exemption. However, that's not much solace for two reasons: 1) It is prohibitively expensive and inefficient for any

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[1] At the time that Municipal funds were first enabled in the 1980s by an amendment to the Internal Revenue Code permitting the flow-through of tax-exempt income in a mutual fund, municipal bonds were mostly issued and sold as long-term, fixed-rate bonds. A money market fund, however, was only permitted to invest in securities with very short remaining maturities (at the time, a maximum of 13 months), and it was (and is) required to maintain a short average portfolio maturity. The reason for this is to enable the money market fund to maintain a stable share price.

Rule 2a-7 under the Investment Company Act limits the investments of money market funds to very high quality, short-term securities. High quality securities, with minimal credit risk, do not fluctuate in value due to credit considerations. Securities with very short remaining maturities have minimal interest rate risk, meaning they do not fluctuate in value due to changes in market interest rates.

The so-called Variable Rate Demand Note ("VRDN") is a structure that was created specifically to enable state and local governments, and other tax-exempt issuers, to access the new pool of capital represented by Municipal MMFs. The VRDN is tailored to satisfy the unique and specific requirements that a bond must meet in order to be purchased by a Municipal MMF.

The birth of tax-exempt mutual funds, and the Municipal MMF, transformed the supply and demand dynamics of the municipal credit markets. The creation of the VRDN transformed the short end of the spectrum by enabling a very large pool of financing capacity at the short-term, tax-exempt, capital markets rate (i.e, the lowest possible cost).

[2] When market rates went to zero following the financial crisis, the economic value of the tax exemption for municipal income declined and total Municipal MMF assets from $500B to $250B. Normally, this evaporation of investors would have increased municipal borrowing costs, but the Fed injected $3 trillion of liquidity into the financial system, locking rates at zero.

entity to raise capital by selling their short-term bonds individually to investors, one by one. 2) It is far more efficient for banks, trusts or partnerships to aggregate individual investors and invest in Municipal MMFs. However, this is now blocked by the "natural persons" restriction in the 2014 Amendments.

Based on the above, there are serious limitations on the demand side, all of which are the result of post-crisis MMF and banking regulations.

Those who oppose the sound remedies contained in S. 1117[3] make three arguments, none of which pass close scrutiny as the above discussion clearly demonstrates.

- Some say that the increase in municipal borrowing costs simply matched the level of the Fed's rate increases over similar time frames. While nominally correct, that argument ignores the KEY driver of "demand" from investors, which is the tax exemption of municipal interest. As the Treasury Strategies study provided to the Committee before the hearing[4] points out, at a 40% all-in tax bracket, investors will be demanding municipal interest of 60% of the taxable market rate (1 - 40%). The study shows that muni borrowing costs based upon the SIFMA index are well above the tax-adjusted treasury rates.[5]

- Some say that more time is needed in order to assess the impact. It's been four years this month since the SEC adopted the 2014 Amendments and investors and borrowers began preparations. It's nearly two years since the 2014 Amendments were fully implemented. The impact was swift with assets plunging over 40% prior to implementation and they have barely budged since then. It would seem, in this era of instantaneous market efficiencies, that more than enough time has passed to fully assess the impact.

- Some say that the market will eventually reach equilibrium. Certainly, it will. A fundamental tenet of economics is that markets move quickly to achieve equilibrium. We could argue that it already has, and the new equilibrium is not a good place for either investors or municipal borrowers. Given the contraction of investor "demand" and the resulting shrinking of the available capital pool, municipalities achieve equilibrium by a

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[3] In addition to GFOA's support, S. 1117 is supported by county treasurers, commissioners and other officials; mayors and other municipal officials; primary and secondary, and higher education; collectively bargained skilled tradesmen; and business and industry in Ohio and across the country. Supporting national organizations include the American Association of Metropolitan Water Agencies, Association of Financial Professionals, Association of School Business Officials International, Government Finance Officers Association, National Association of Counties, U.S. Conference of Mayors, National League of Cities, International City / County Management Association, National Association of Health and Educational Facilities Finance Authorities, International Municipal Lawyers Association, National Council of State Housing Agencies, American Public Power Association, Large Public Power Council, State Financial Officers Foundation, U.S. Black Chambers, and U.S. Chamber of Commerce.

S. 1117 is opposed by the largest investment management firms in the world, such as Blackrock and Vanguard, and in turn, their industry trade association, the Investment Company Institute. These firms believe their support in the regulatory process for curtailing access to the nongovernment money market fund brought them relief from Financial Stability Oversight Council ("FSOC") designation as nonbank Systemically Important Financial Institutions ("SIFIs"). To GFOA's knowledge, FSOC's nonbank SIFI candidates are the only opponents of the bill.

[4] www.treasurystrategies.com/industry_insight/h-r-2319-s-1117-the-importance-of-restoring-state-and-local-government-access-to-money-market-funds (June, 2018).

[5] The paper Vanguard circulated to all Committee offices prior to the hearing is simply erroneous in that it does not tax-adjust these rates.

combination of either: a) paying higher rates to attract more investors into the market, or b) reducing "supply" of short term borrowing by either curtailing projects or entering into much higher cost long-term debt arrangements.[6]

It's simply not fair that small municipalities, school districts and community hospitals are suffering this "new equilibrium" which includes higher borrowing costs accompanied by a diminished pool of capital.

The following is in response to your specific questions.

Question 1: Your written testimony states that the "lack of investor appetite for floating-NAV tax-exempt MMF's resulted in municipalities issuing variable rate demand bonds seeing their borrowing costs nearly double the Federal Reserve's rate increases over the same period." Earlier in your testimony, you reference the period between January 2016 and April 2018.

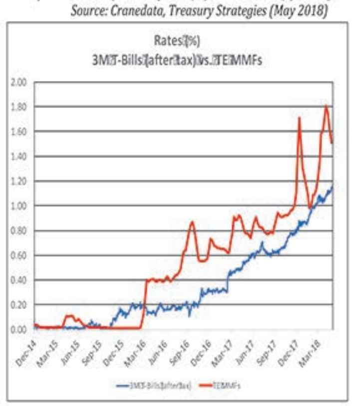
Please provide a comparison of the most relevant municipal borrowing rate (or more than one) to the federal funds target rate (or other applicable comparison) for the thirty-six months ending June 30, 2018. In your comparison, please explain each of the rates used (i.e., an index, midpoint of rate range, etc.).

GFOA refers you to a recent report by Treasury Strategies containing the following chart, which uses Municipal MMF yields as a proxy for municipal borrowing costs, and compares it to 3-month Treasury Bills on an after-tax basis over the past 40 months. This report, entitled "The Importance of Restoring State and Local Government Access to Money Market Funds" is attached as **Attachment 1**.[7]

[6] The fact that markets reach equilibrium is neither inherently good nor bad. It is simply the point of intersection where supply equals demand. For the nay-sayers to essentially say that in time, the muni markets will reach equilibrium is deceptive. It absolutely does not imply that the new equilibrium will be "good". For example, in the 1980s, manufacturing declined in the Midwest due to offshoring. Voila, in short order, the market reached equilibrium (just as the S.1117 nay-sayers would have predicted) but that was NOT a good equilibrium. The new equilibrium included higher unemployment and lower economic growth. Similarly, the municipal funding equilibrium includes higher cost borrowings and a smaller pool of capital. S. 1117 can help remedy that.

[7] The report, in addition to being attached, is at www.treasurystrategies.com/industry_insight/h-r-2319-s-1117-the-importance-of-restoring-state-and-local-government-access-to-money-market-funds

Comparison Municipal MMF yields (%) vs. 3M T-Bills (after tax),
Source: Cranedata, Treasury Strategies (May 2018)



The report notes that, before the 2014 Amendments to Rule 2a-7 went into effect, municipal short-term borrowing rates were consistently lower than the after-tax Fed Funds and T-Bill rates. Since then, however, municipal rates have been well above the after-tax Federal Funds rate.

The report further notes that municipalities fortunate enough to continue selling Variable Rate Demand Notes ("VRDNs") to Municipal MMFs saw borrowing costs skyrocket at more than double the Fed rate increase – 170 bps vs. 75 bps after tax. Other municipalities would have to borrow from different investors, or replace their VRDNs with bank loans at much higher rates and longer maturities.

To provide more context with regard to VRDNs,[8] the SEC's 2014 Amendments took away the stable NAV for non-natural persons investing in nongovernment MMFs (effective October 2016), causing a decline of over 40 percent of the total assets of the funds. As assets left

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[8] The VRDN is a type of short-term debt security designed specifically to be purchased and held by a money market fund.

Ordinarily, a money market fund must use the maturity date shown on the face of a bond to measure its remaining maturity. However, Rule 2a-7 provides exceptions to this rule for variable and floating rate bonds that "are subject to a demand feature." Rule 2a-7 treats both of these types of bonds as having a maturity equal to "the period remaining until the principal amount can be recovered through demand," unless, in the case of variable rate bonds, the period remaining until the next interest rate adjustment is longer than the period remaining until the demand right can be exercised, in which case the longer period is used to measure the bond's maturity. Rule 2a-7 defines a "demand feature" as "a put that entitles the holder to receive the principal amount of the underlying security."

The standard convention for the VRDN structure is a variable interest rate that is reset to the short-term market rate every seven days, combined with a put that can be exercised on seven days' notice. This causes the bond, under Rule 2a-7, to have a remaining maturity of seven days. If the bond should be put (e.g., to satisfy redemptions in the fund), the structure has a "remarketing agent" that places the bond with a different MMF. There will normally be a standby purchaser in the structure, as well, to hold the bond, if necessary, until it is placed in a different fund. Typically, VRDNs can also be converted into a long-term mode and re-marketed as long-term, fixed-rate bonds if it makes sense to do so.

Further, the structure enables credit enhancement, if necessary. Many municipal issuers (e.g., the City of Columbus, OH) are of sufficient short-term credit quality so as to be eligible investments for a money market fund. Where this is not the case, the issuer's credit quality can be bolstered via the backstop of a bank letter-of-credit. This adds cost – the issuer must now pay a fee for the LOC as well as the interest on the bonds; but, normally, the total cost is still far less than issuing a long-term, fixed-rate bond.

Municipal MMFs in 2016, the funds tendered VRDNs to fund the redemptions. Those VRDNs were then "re-marketed" with re-marketing agents moving the weekly interest rates up to the level necessary to clear the market and get the bonds placed (either in other MMFs or with non-MMF buyers). The supply of VRDNs exceeded the demand from Municipal MMFs, so the interest rate had to go up in the auction process until it attracted a buyer.

The key metric impacting the cost of financing to state and local government is the level of assets in Municipal MMFs.[9] Municipal MMFs dramatically increased both the supply of financing capacity at the short end of the spectrum, as well as the efficiency of issuing bonds there. MMFs are an extraordinarily effective vehicle to gather and concentrate cash into easily accessible, stable pools that would then bid against each other to buy VRDNs and other short-term, tax-exempt paper (i.e., tax anticipation notes, etc.). Otherwise, issuers have to work through underwriters, dealers and banks to find other, individual buyers.

With or without the MMF, the short-term, variable rate, tax-exempt end of the spectrum will always have, on a relative basis, the lowest cost because it has the lowest credit and interest rate risks. Eliminating the MMF does not alter that market dynamic. Rather, it changes the market supply-demand equation in a fashion that causes rates to go up across the spectrum.[10]

With the loss of over $120 billion in demand from Municipal MMFs due to the 2014 Amendments, VRDN rates have increased far beyond the increase in market rates. The supply of VRDNs now exceeds the demand from Municipal MMFs for VRDNs such that the result of the market auction process is to increase rates to find the maximum that VRDNs are willing to pay to remain in Municipal MMFs. Issuers must also find alternative sources of financing. They either must sell directly to individual investors in a less efficient way, issue long-term debt, or borrow from banks at a higher cost. This increased demand out the spectrum raises rates for those already higher-cost sources.

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[9] The same is true for Prime MMFs. Nearly $1.2 trillion has exited Prime and Municipal MMFs. Prime MMFs have seen a 67 percent drop from $1.41 trillion in January 2015 to $470 billion on May 1, 2018.

[10] Issuers, such as a city, state or agency, with substantial financing needs are regularly borrowing, issuing and re-financing based on their needs, unique financial circumstances, and market conditions. Typically, any issuer will have a combination of different types of debt on its balance sheet – multiple borrowings of different types and terms. What issuers desire is a competitive universe of different sources and options that enable them to choose the best fit, and get to the lowest cost, based on their particular needs and circumstances.

There are various choices in financing for governments, universities, hospitals, housing, community organizations and business. Broadly speaking, these choices include: whether to borrow short or long term; whether to have a variable or fixed interest rate; whether to borrow from a bank or in the capital markets; and, if in the capital markets, whether to issue taxable or tax-exempt.

These sources of financing, and structuring choices, can be put on a spectrum of cost. Under normal credit market conditions, short-term, variable-rate, tax-exempt, capital markets financing will be at the lowest possible cost end of the spectrum. Long-term, fixed-rate, taxable, bank financing will be at the opposite, highest-cost end of the spectrum. The reason long-term, fixed-rate financing normally costs more is because there are higher interest rate and credit risks to investors, and they require higher compensation to take more risk.

One of the key reasons why borrowing in the capital markets is less expensive than borrowing from a bank is because the capital markets are, in effect, an auction. There are a plethora of buyers for bonds in the marketplace. They bid against each other to buy the bonds, and this drives the price up, and the yield down, so that the issuer receives the lowest possible cost as compared to a one-on-one negotiation with a bank. Issuers benefit from a lower cost as the market mechanism for buyers to bid, or compete, against each other becomes more efficient. See, *e.g.*, https://www.brown.senate.gov/newsroom/press/release/brown-demands-big-banks-use-tax-cuts-to-bring-back-us-jobs

The cynics will argue[11] that, over time, there will be a new market equilibrium – existing VRDNs will be refinanced, and the issuance of new VRDNs will fall, until VRDN rates fall back in line with market short-term rates. This is true, but it misses the crucial point. Dramatically reducing the pool of available short-term credit forces issuers to go to other lending sources, such as long-term, fixed-rate, and/or bank financing, where the cost is much higher and will be pushed up even more by the new demand. Without assets in Municipal MMFs, state and local government have lost access to a large pool of the lowest cost, short-term, tax-exempt, capital markets financing.

GFOA would note that this impact was predicted by Idaho State Treasurer Ron Crane in his testimony before a hearing of the Senate Banking Securities Subcommittee on May 16, 2016, before the implementation of the 2014 amendments.[12] Treasurer Crane testified as to the unfolding impact, and gave a forecast based on a Treasury Strategies study attached to his written testimony. He testified that:

> "… as part of the July 2014 amendments to Rule 2a-7, the SEC also adopted a requirement, effective on October 14 of this year, which in effect eliminates the utility of any money market fund to investors who are not "natural persons" (in the terminology of the Rule) unless the fund invests exclusively in U.S. government securities.
>
> "Under this new requirement, any tax-exempt or prime money market fund accepting any investor other than a 'natural person' will no longer be able to offer and redeem shares based on amortized cost valuation of its portfolio to produce a stable, $1 net asset value (NAV). Instead, such funds will have to apply a fluctuating or "floating" NAV using market-based estimated values. Simply, again, the floating NAV goes beyond regulation of the money market fund to just kill it as a cash management tool. I do not believe cash investors, such as myself, want, or will use, a floating NAV fund for cash investments.[13]

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[11] See *supra* notes 3 and 6. Blackrock's paper, circulated to all Committee offices prior to the hearing, is at https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-us-mmf-reform-assessing-the-impact-january-2018.pdf. Blackrock questions whether the cause and effect of the excess of VRDN rates over the market rate is the loss of Municipal MMF assets. Clearly, as a matter of basic supply and demand, it is; but even if it is not, the key point here is that, in any event, long-term, fixed rate, and/or bank financing is going to be more expensive than borrowing from Municipal MMFs.

[12] See https://www.banking.senate.gov/hearings/sii-improving-communities-and-businesses-access-to-capital-and-economic-development

[13] The SEC's 2014 Amendments were in response to an FSOC "ultimatum" to the SEC in the wake of a 2012 SEC rulemaking effort that failed to attract the necessary three SEC commissioner votes to even propose a rule (of a SEC with a Democratic chair and three Democratic commissioners). FSOC demanded that the SEC do one or more of three things to MMFs: capital requirements, redemption restrictions and/or floating the share price ("FNAV").

The SEC discarded FSOC's capital requirements option, but put out a proposed rule for comment that itself had three options: (1) FNAV, (2) redemption restrictions, or (3) both FNAV and redemption restrictions. Blackrock, the largest investment management firm in the world, commented as follows with respect to (3) - the combination of FNAV and redemption restrictions - in a letter dated September 12, 2013 (https://www.sec.gov/comments/s7-03-13/s70313-115.pdf at p. 13):

> "If one of the stated objectives of the further reforms is to preserve the benefits of MMFs and have a viable product for investors to use, this proposal is not workable. **A rational investor would not purchase a MMF, with the strict portfolio requirements of Rule 2a-7, that has both a floating NAV and has the prospect of a liquidity fee and gate.**"

> "Thus, by October 14, all investors other than 'natural persons' are forced to leave any stable value, dollar per share, prime or tax-exempt money market fund. Since these investors are managing cash, they will be looking to move to a different, stable-value cash management vehicle. As a practical matter, this means most will either put their cash in a money market fund investing exclusively in U.S. government securities or deposit their cash in the bank.
>
> "In either case, that money will no longer be available in the portfolio of a prime or tax-exempt fund to loan to businesses or invest in tax-exempt notes and bonds of Idaho, other state and local governments, and other nongovernment issuers such as hospitals and universities…
>
> "…Treasury Strategies has concluded that this one SEC requirement, by itself, will reduce the assets in tax-exempt money market funds by at least 40 percent."[14]

The impact of the 2014 Amendments on tax-exempt issuers in Ohio can be clearly seen in **Attachment 2**. It shows both the loss of financing and the increase in cost on an issuer-by-issuer basis. Overall, MMF holdings of debt of Ohio municipalities fell 51 percent from $4.61 billion to $2.24 billion between January 2016 and April 2018. Originally, MMFs held 345 Ohio issues. That fell to 193 as a result of the 2014 Amendments. Thus, over 150 debt issues had to be funded elsewhere, almost certainly at a higher cost. For those municipalities fortunate enough to continue receiving funding from Municipal MMFs, the median rate rose by 1.69 percent from 0.10 percent to 1.79 percent. That is more than double the after tax-adjusted Fed rate increases over the period, which was 0.75%.[15]

> "We would strongly urge the Commission not to adopt a proposal that would combine standby liquidity fees and gates and a floating net asset value as features of the MMF as this **combination would raise the likelihood that [nongovernment] MMFs would no longer be offered, with significant impact on investors, issuers and the short-term funding markets**." [Emphasis added.]

The SEC then proceeded to adopt the combination of FNAV and redemption restrictions in its 2014 Amendments.

14 The Treasury Strategies study was a very simple exercise. As a threshold matter, the 2014 Amendments drew a distinction between "natural" and "non-natural" persons, and said that "non-natural" persons would have to leave non-government, stable value MMFs. Thus, the impact would be, at least, the amount of assets in these funds in accounts of "non-natural persons". Treasury Strategies simply surveyed both the largest MMF sponsors maintaining direct shareholder accounts (i.e., that know whether their shareholders are non-natural persons, or not), as well as intermediaries maintaining omnibus accounts. The sponsors and intermediaries told Treasury Strategies, upon inquiry, what the amounts were.

When you compare the Treasury Strategies study to the SEC's adopting Release for the 2014 Amendments, you see that the SEC did not assess and weigh the impact of its rule. In its Release, the SEC asserted that "institutional" [non-natural person] investors likely held less than 15 percent of tax-exempt money market fund assets. *Money Market Fund Reform; Amendments to Form PF*, www.sec.gov/rules/final/2014/33-9616.pdf at p. 244; 79 Fed. Reg. 47736 (Aug. 14, 2014). The SEC was relying on industry data differentiating "institutional" and "retail" funds by criteria such as minimum account size; not the distinction in its rule of "natural" vs. "non-natural" persons. In addition, the SEC asserted that such data overstated "institutional" assets because omnibus accounts likely consisted of retail [natural person] investors. Thus, the SEC assumed, without comparable data or performing its own study, that its action would not significantly impact the assets of Municipal MMFs.

15 Nominal increase of 1.25% times (1-minus 40% marginal tax rate). (Vanguard's paper does not make this adjustment.)

The general impact on tax-exempt issuers is illustrated in the Treasury Strategies report attached as **Attachment 1.**[16] It is an analysis showing the loss of financing capacity and the rise in financing cost both in general and in selected states, including all of the states represented on the Senate Banking Committee.

Question 2: Please explain how you assess the impact of the change in corporate tax rates on the demand for municipal securities.

See response to Question 3.

Question 3: Please explain how you assess the impact of the change in individual tax rates and the limit on the deductibility of state and local tax on the demand for municipal securities.

Under the federal tax code, corporate and individual investors are not required to pay federal income tax on interest earned on most bonds issued by state and local governments. It will take some time for GFOA to quantify the impact of lower corporate and individual tax rates, and the limit on the deductibility of state and local taxes, each specifically on the demand for municipal securities. However, we do know that the Tax Cut and Jobs Act of 2017 has adversely impacted the cost of borrowing by state and local governments due to the loss of advanced refunding and now state and local government issuers need alternative sources of liquidity to maintain cost-efficient access to working capital and financing for infrastructure investment. Until recently, MMFs were a significant source of that liquidity. Such funds provide state and local governments with very low-cost variable rate financing as an alternative to issuing fixed-rate bonds. Unfortunately, just as Congress made fixed-rate municipal debt generally costlier and less available, the SEC's 2014 Amendments governing MMFs are having the same effect of reducing liquidity in the short-term municipal debt market and driving up the cost of borrowing when it is needed most.[17]

Question 4: Using publicly available sources, please provide the annual issuance of variable rate demand notes / obligations by state and local governments for each calendar year beginning with 2010 through, and including, 2017. For any year-over-year period where there is a decline, please explain the factors you believe caused such decline.

For data on municipal variable rate securities, including VRDNs, GFOA would refer the Committee to the 2017 MSRB Fact Book.[18] As noted previously, since the VRDN is a structure created specifically to meet the unique requirements of Rule 2a-7 for permissible investments of MMFs, the annual issuance of VRDNs simply parallels the growth or decline of assets in Municipal MMFs.

The aggregate assets of Municipal MMFs grew steadily for over 25 years from inception in the 1980s until 2009, which marked the beginning of the loss of "normal" market conditions. Two factors occurred that caused a decline in VRDNs. First, short-term interest rates fell to nearly zero and held there for eight years. This took away a key benefit of the Municipal MMF – tax-

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16 See *supra* notes 4 and 8.

17 The limit on the deductibility of state and local taxes inhibits the ability of state and local government to increase taxes and, if anything, places an even greater premium on the demand, or need for low cost financing.

18 http://www.msrb.org/~/media/Files/Resources/MSRB-Fact-Book-2017.ashx?la=en beginning on page 51.

exempt income and, as a result, assets in the funds fell from $500 billion to $250 billion at the end of 2015.[19]

Enacting S. 1117 and thereby restoring the stable value for nongovernment money market funds will restore the utility of the product for investors, bring the lost assets back into the funds, and enable assets to return to previous highs as short-term interest rates return to their normal range. This, in turn, will result in a substantial increase in the issuance of new VRDNs.

Question 7: Please explain the impact of regulatory changes, other than the SEC's 2010 or 2014 rules, on the supply or demand for municipal money market securities.
As applicable, please discuss bank capital and other regulations that may affect variable rate demand notes / obligations, such as the liquidity coverage ratio, leverage ratio, capital ratio, and the Volcker rule, and any others that you believe could be relevant.

Without Municipal MMFs, there are no bank capital or other regulations that may affect VRDNs, because VRDNs are a structure that is specific to MMFs. If the nongovernment MMF is restored by the enactment of S. 1117, and with the Federal Reserve no longer holding short-term market interest rates at zero, the potential is there for Municipal MMF assets to grow from the present $130 billion to as much as $500 billion. At that point, the primary bank regulation affecting VRDN issuance is the same issue that hindered bank purchases of municipal securities for their own account: the increased cost of obtaining bank credit enhancement for a VRDN due to changes in risk capital weighting for bank letters of credit. Bank credit enhancement is more difficult to obtain, and costs more, due to regulatory changes in bank capital requirements.

However, this is primarily a cost issue in the marketplace that is factored into a municipal issuer's decisions on the types and terms of debt it will issue in its particular circumstances. There are alternative, competitive nonbank sources of credit enhancement (e.g, bond insurers). An issuer needing credit enhancement in order to meet the credit quality requirements to be a permissible investment for a Municipal MMF will weigh the combined interest and credit-enhancement cost of the VRDN (or other structure) against what it will cost to issue debt in a form that does not require credit enhancement.

Unrelated to VRDNs, a bank regulation of concern to GFOA members is the liquidity coverage ratio rule approved by federal regulators in 2014, which classifies foreign sovereign debt securities as HQLA while excluding investment grade municipal securities in any of the acceptable investment categories for banks to meet new liquidity standards. GFOA believes that not classifying municipal securities as HQLA will increase borrowing costs for state and local governments to finance public infrastructure projects, as banks will likely demand higher interest rates on yields on the purchase of municipal bonds during times of national economic stress, or even forgo the purchase of municipal securities. The resulting cost impacts for state and local governments could be significant, with bank holdings of municipal securities and loans having increased by 86 percent since 2009.

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[19] There was a substantial cost to state and local government, in terms of increased financing costs due to the loss of assets from Municipal MMFs between 2010 and 2015. Issuers were forced to instead issue long-term bonds. However, the cause in this period was credit market conditions in response to Federal Reserve policies that presumably would eventually reverse. *Supra*, note 2. Remarkably, investors continued to use Municipal MMFs to hold and invest $250 billion in cash, even without material tax-exempt income. This demonstrates the importance of the stable NAV. If it was income that was most important to investors in cash management, they could have moved their assets to other mutual funds with fluctuating NAVs, such as ultrashort bond funds.

Fortunately, Congress recently addressed some of this concern with enactment of S. 2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act, which included a provision to classify investment grade municipal securities as HQLA. The core features of investment grade municipal securities are consistent with all of the criteria characterized as HQLA, including limited price volatility, high trading volumes and deep and stable funding markets.

Cash Management (Questions 5 and 6)

The stable share price of MMFs is a critical operational feature that makes them useful to both state and local governments as investors of cash balances, and all other types of organizations as well. Movement to a fluctuating NAV has made nongovernment MMFs far less useful to investment officers. Comments submitted by state and local governments to SEC and FSOC dockets during the regulatory process were very blunt in stating their opposition to imposing a floating NAV requirement on MMFs.[20]

Question 5: What percentage of state and local governments have access to local government investment pools?

Accounting requirements for state and local governments are established under applicable state and local law, rules and policy as well as standards set by the Government Accounting Standards Board ("GASB"). These state and local requirements and GASB Standards also apply to LGIPs, which are investment pools operated by state governments to hold state and local government assets. Many LGIPs are operated by state governments to invest liquid assets and have features similar to a MMF, including daily liquidity and a stable unit value of $1 per unit.

There are now more than 107 LGIPs used in 44 states, with total assets in excess of $225 billion. The twenty-five largest LGIPs accounted for approximately three-quarters of total LGIP assets.

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[20] *See. e.g.* Letter from Conference of Mayors to Commission (July 18, 2013) (available in File No. S7-03-13); Letter from North Carolina Metropolitan Mayors Coalition to Commission (July 24, 2013) (available in File No. S7-03-13); Letter from Association of Indiana Counties to Commission (Aug. 13, 2013) (available in File No. S7-03-13); Letter from Government Finance Officers Association, International City/County Management Association, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National League of Cities, National Association of Counties, U.S. Conference of Mayors, American Public Power Association, and Council of Infrastructure Financing Authorities to Commission (Aug. 19, 2013) (available in File No. S7-03-13); Letter from Commonwealth of Kentucky, Office of Financial Management to Commission (Sept. 6, 2013) (available in File No. S7-03-13); Letter from Massachusetts Municipal Association to Commission (Sept. 9, 2013) (available in File No. S7-03-13); Letter from Government Investment Officers Association to Commission (Sept. 10, 2013) (available in File No. S7-03-13); Joint Letter from Mayors of: Irving, Texas; Fort Worth, Texas; Louisville, Kentucky; Racine, Wisconsin; Cincinnati, Ohio; Raleigh, North Carolina; Salt Lake City, Utah; Arlington, Texas; Mesa, Arizona; Covington, Kentucky; Baltimore, Maryland; Chicago, Illinois to Commission (Sept 12, 2013) (available in File No. S7-03-13). *Accord* Letters from American Public Power Ass'n *et al* (Jan. 10, 2011, Mar. 8, 2012 and Feb. 13, 2013) (available in various Commission comment files); Letter from Hon. Michael B. Hancock, Mayor, City and County of Denver (Jul. 25, 2012) (available in File No. 4-619); Letter from Hon. Stephanie Rawlings-Blake, Mayor, City of Baltimore (Jul. 20, 2012) (available in File No. 4-619); Letter from Utah Ass'n of Counties (Jun. 27, 2012) (available in File No. 4-619); Letter from New York State Ass'n of Counties (Jun. 20, 2012) (available in File No. 4-619); Letter from Hon. James L. Mcintyre, Treasurer, State of Washington (Nov. 15, 2011) (available in File No. 4-619); Letter from New Mexico Ass'n of Counties (Jan. 28, 2011) (available in File No. 4-619); Letter from Hon. Ralph Becker, Mayor, Salt Lake City Corporation (Jan. 13,2011) (available in File No. 4-619); Letter from National Ass'n of State Treasurers (Dec. 21, 2010) (available in File No. 4-619).

Approximately two-thirds of LGIPs are operated as stable value funds that seek to maintain a stable NAV.[21]

All LGIPs are now permitted under GASB Standards to elect to value their portfolios at amortized cost. However, until December 2015, GASB required that LGIPs operate in a manner consistent with Rule 2a-7 in order to use amortized cost to value securities. In response to the 2014 Amendments, GASB issued Accounting Statement No. 79 on December 23, 2015, which effectively de-linked LGIP financial reporting from Rule 2a-7 in advance of the effective date of the 2014 Amendments. In the new Statement, GASB sets forth requirements for average investment maturity, quality of portfolio assets, diversification of investments, and portfolio liquidity which are similar to Rule 2a-7, and which it determined are sufficient to justify the use of amortized cost as an approximation of fair value. As such, GASB has repudiated the SEC's analysis and justification for fluctuating NAV requirement in the 2014 Amendments.

The LGIP is an excellent case study in how a regulator can underestimate the marketplace. In discounting comment, the SEC did not anticipate the unwillingness of state and local governments, and others, to accept a fluctuating NAV. In view of the facts that: (a) states currently could choose to amend their statutes and policies to operate LGIPs as floating NAV pools, but have not done so; (b) virtually all LGIPs that are intended to hold liquid assets operate with a stable NAV; and (c) state and municipal governments have loudly voiced their opposition to imposing a fluctuating NAV, it seems unlikely that states would rush to embrace a fluctuating NAV for either LGIPs or for MMFs simply because the SEC amended Rule 2a-7.

LGIPs are an important and valuable cash management vehicle for state and local government. However, the nature and extent of LGIP offerings varies substantially from state to state, depending on the resources available; and state and local governments have always relied on the ability to choose from an array of registered MMF options alongside their states' LGIPs. Local governments, without either an LGIP offering or a prime money market fund are left with no ability to access prime money market instruments through a pooled investment vehicle.

LGIPs are exempt from registration under the Investment Company Act, and thereby Rule 2a-7 and SEC regulation, due to an exemption for funds with only government entity participants. Therefore, while a cash management alternative to MMFs for local governments, LGIPs are not available to the larger universe of other non-government community organizations (such as hospitals and universities); or to businesses.

Question 6: Your written testimony states "many governments have specific state or local statutes and policies that require them to invest in financial products with a stable NAV".

(1) How many state or local governments have such restrictions? (2) Of those, how many are statutes (or the equivalent)? How many are policies? (3) How many, or what percentage, have both? (4) Of the policies, how many can be changed by amending policy (rather than a legislative change)?

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[21] Source: iMoneyNet Special Report Government Investment Pools: Investment Strategies, Facts, Figures and Trends. See *also*, http://www.imoneynet.com/products-services/special-reports.aspx

Overview - A Fiduciary Process.

GFOA's best practice recommends that all state and local governments have investment statutes and policies adopted by the governing body.[22] The establishment of investment policy is at the heart of a fiduciary investment process. The purpose of an investment policy statement is to document the investment plan and guide consistent, informed decision-making. It is to ensure that an investment strategy is based on the unique needs and objectives of the particular investor or entity; and that investment performance is measured against those unique needs and objectives. This is the essence of fiduciary behavior: acting solely in the best interest of beneficiaries based on their unique circumstances.

Managing and investing taxpayer cash and other funds is like everything else in state and local government: it starts with asking what is the purpose to be achieved and what is in the best interests of citizens, taxpayers and communities?

Investment officers first define their needs and goals; and then seek to craft an investment strategy, and make investment choices, that meet those needs and accomplish those goals. Ideally, financial product providers are competing in the marketplace to provide the best possible solutions and services in response to investor needs and goals.

This market-driven system breaks down when the terms of financial products and services are dictated in a fashion that destroys the utility of the product to the investor. Notwithstanding broad, deep and overwhelming public comment in the regulatory process, the decision was made in Washington to disregard the expertise and needs of state and local governments, including those in Ohio.

Key Points.

First, investment statutes and policies are not arbitrary requirements that can be readily changed so as to suddenly enable state and local government investors to use MMFs with fluctuating share prices ("FNAV funds").

The key point is that the statutes and policies are the reflection, or expression, of a host of underlying needs and goals for how money is invested and cash is managed. Changing the policy does not change the underlying needs and goals. Rather, changing the policy would be subverting a fiduciary decision-making process that many in Congress support.[23]

The stable share price ("stable NAV") is a critical, baseline need and requirement for investors in using MMFs for cash management. It is these needs and requirements that then become the basis for drafting investment statutes and policies. Investors from across the country, and in Ohio, overwhelmingly expressed their position to both FSOC and the SEC in the regulatory process. But the fluctuating NAV was imposed nonetheless, and the result was that investors redeemed $1.2 trillion dollars from the funds that no longer had a stable NAV and therefore no longer met their needs.[24]

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[22] https://www.gfoa.org/investment-policy

[23] See, e.g., Letter of Senators Patty Murray, Elizabeth Warren, Sherrod Brown, Ron Wyden and Cory A. Booker to U.S. Secretary of Labor Alexander Acosta (May 18, 2018) regarding the DOL conflict of interest rule ensuring financial advisers are acting in their clients' best interests. Available at https://thediwire.com/wp-content/uploads/2018/05/Senate-Letter-to-DOL.pdf.

[24] See *supra* notes 13 and 20.

Attached as **Attachment 3** are the following letters to Senator Brown from municipal leaders in Ohio highlighting their concerns as to their duties under state law and investment policy:

- Ohio County Commissioners Association, Ohio County Treasurers Association, Ohio Council of County Officials – outlining that counties have statutory obligations to invest in stable NAV MMFs. This means that many of Ohio's 88 counties fall under this mandate and have been negatively impacted by the 2014 Amendments due to the lack of available, nongovernment stable NAV MMFs.[25]

- Ohio Municipal League – outlines that cities have statutory obligations to invest in stable funds. This means that many of Ohio's 900-plus municipalities fall under this mandate and have been negatively impacted by the 2014 Amendments due to the lack of stable NAV MMFs. Dayton Mayor Nan Whaley's letter is also included.[26]

- University of Toledo – outlines that public universities have statutory obligations to invest in stable VAV funds. Ohio currently has 14 four-year state universities, 24 branch and regional campuses, 23 two-four community colleges and technical colleges, and one public medical college for a total of 62 public higher education organizations, which are many of them are impacted to by the 2014 Amendments.

- The Metro Health System – outlines that many public hospitals have statutory obligations to invest in stable NAV MMFs.

- Plain Township – demonstrates that many of Ohio's townships have statutory obligations to invest in stable NAV MMFs.

Responses to specific questions:

(1) and (2). All state and local governments are both subject to statutory investment restrictions and have formulated specific investment policies as part of their fiduciary investment processes.

Ohio is representative, as noted by the Ohio County Commissioners Association, Ohio County Treasurers Association, Ohio Council of County Officials, Ohio Municipal League, University of Toledo, the Metro Health System, Plain Township and many others (over 80 associations and individuals representing towns, cities, counties, colleges, universities, hospitals, port authorities, businesses and others) in addition to the GFOA.[27]

Virtually all statutes and policies require a stable NAV either as a matter of statute, or as a matter of policy, or both. Almost all statues, nationwide, refer to a MMF registered under the Investment Company Act and may also reference Rule 2a-7 under the

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25 Athens County Commissioner Lenny Eliason, and other county officials, have also written to Senator Brown.

26 Cincinnati Mayor John Cranley, Columbus City Councilman Michael Stinziano, and other municipal officials, have also written to Senator Brown.

27 Cong. Joyce Beatty, Tim Ryan and Marcia Fudge, among other members of the Ohio House delegation, are listening and have responded by co-sponsoring H.R. 2319, the House companion bill to S. 1117. See https://www.congress.gov/bill/115th-congress/house-bill/2319/cosponsors?q=%7B%22search%22%3A%5B%222319%22%5D%7D&r=2 .

Investment Company Act.[28] Until the end of 2016, this requirement, in and of itself, meant investing in a MMF with a stable value. Otherwise, without the reference to "money market fund," any short-term bond fund with a fluctuating share price would be a permissible investment. Some statutes go further and explicitly require that the fund maintain a stable net asset value.[29]

Post-implementation of the 2014 Amendments in October of 2016, Rule 2a-7 now encompasses funds with both stable and fluctuating NAVs. Only "natural persons" can invest in nongovernment funds with a stable share price. Thus, as a literal mater, a state statute enabling a state or local government to invest in a MMF regulated under Rule 2a-7 could now be interpreted to permit a nongovernment fund with a fluctuating share price. However, (a) public officials behaving as fiduciaries know and understand that was not the intent of the statute; and (b) regardless of the technicalities, as a practical matter, the fluctuating NAV funds still do not meet their fundamental needs and operational requirements.

That is expressed and demonstrated by the fact that investors have overwhelmingly withdrawn their money from nongovernment, floating NAV funds. These "non-natural person investors" have a choice. Regulators can require the floating NAV; but regulators cannot force investors to invest.

(3) and (4). A survey has not been performed, to GFOA's knowledge, that would indicate, in percentage terms, and on a nationwide basis, how many statutes and/or policies would have to be changed to enable a FNAV fund. There are two basic reasons:

First, each state is different from every other state. Each has a multitude of political subdivisions, agencies and funds. Each state, in and of itself, then has a corresponding

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[28] *See, e.g.,* Ariz. Rev. Stat. § 35-313 ("The state treasurer shall invest and reinvest trust and treasury monies in any of the following items: . . . 8. Securities of or any other interests in any open-end or closed-end management type investment company or investment trust . . . registered under the investment company act of 1940 . . . . For any treasurer investment pool that seeks to maintain a constant share price, both of the following apply: (a) The investment company or investment trust takes delivery of the collateral for any repurchase agreement either directly or through an authorized custodian. (b) The investment policy of the investment company or investment trust includes seeking to maintain a constant share price."); Colo. Rev. Stat. § 24-75-601.1 ("It is lawful to invest public funds in any of the following securities: . . . (k) Any money market fund that is registered as an investment company under the federal "Investment Company Act of 1940", as amended, if . . . [t]he investment policies of the fund include seeking to maintain a constant share price . . . ."); Del. Code Ann. tit. 31, § 4013 ("In addition to its other powers, [the Delaware State Housing Authority] is hereby granted, has and may exercise all powers necessary or appropriate to carry out and effectuate its corporate purposes, including, without limitation, the following . . . (17) To invest any funds not needed for immediate use or disbursement including any funds held in reserve in the following . . . l. Shares of any investment company that . . . [m]aintains a constant net asset value per share . . . ."); Letter from County Commissioners Association of Ohio to FSOC (Dec. 21, 2012) (available in File No. FSOC–2012–0003) ("County governments in Ohio operate under legal constraints or other policies that limit them from investing in instruments without a stable value. If money market funds are required to float with their NAVs, many counties in Ohio would be forced to use alternative funds that are less regulated, less secure, and less liquid"); Letter from Metropolitan Mayors Caucus to SEC (Mar. 28, 2012) (available in File No, 4.619) ("Many governments are required by statute to invest in financial products which bear less risk and have stable values. Money market funds are the investments used to ensure compliance with these state and local laws.")

[29] *See, e.g.,* Me. Rev. Stat. tit. 5, § 135 ("When there is excess money in the State Treasury that is not needed to meet current obligations, the Treasurer of State may invest . . . those amounts in . . . so-called 'no-load' shares of any investment company registered under the federal Investment Company Act of 1940, as amended, that complies with Rule 2a-7 guidelines and maintains a constant share price.").

multitude of specific statutes that correspond to those subdivisions, agencies and funds. Each political subdivision, agency and fund, in turn, formulates its own investment policies.[30] It is not a matter of compiling and tabulating 50 statutes and policies. **Attachment 4** is an illustrative matrix for Illinois.

Second, focusing, in isolation, on these statutes and policies is missing an important point. The real issue is listening to the underlying needs and wants of investors, as manifested in the statutes and policies. Based on how investors are actually investing their money, the vast majority not just require, but demand, a stable NAV.

Questions for Mr. Chris Daniel, Chief Investment Officer of the City of Albuquerque, Government Finance Officers Association, on behalf of Senator Cortez Masto:

In the past year, we have had two high-profile chronic liars that defrauded investors. Elizabeth Holmes from Theranos sold a false blood testing system and raised $700 million from wealthy investors. Martin Shkreli is serving a seven-year prison sentence for lying about returns to his investors. Shkreli specialized in buying drugs, like Daraprim, a 62-year-old life-saving drug that helps newborns and people with HIV, and then raising the price from $13.50 to $750 a pill. Both Holmes and Shkreli ran private companies. As private firms, they did not have strong oversight from state regulators or from the Securities and Exchange Commission. Elizabeth Holmes' firm, Theranos, bilked investors of more than $700 million dollars. Martin Shkreli was sentenced to seven years in prison for lying to his investors.

- **Of the six capital formation bills we considered which of these are going to help investors distinguish good-faith pipe dreams from fraudsters like Elizabeth Holmes and Martin Shkreli?**

- **Which bills do you think would make it easier for fraudsters to rip off investors?**

GFOA's testimony focused on S. 1117. Our organization does not have the expertise to comment on the other capital formations bills that were discussed at the hearing.

Questions for Mr. Chris Daniel, Chief Investment Officer of the City of Albuquerque, Government Finance Officers Association, on behalf of Senator Menendez:

Do you think that investors who have left municipal money market funds would come back into the funds if those funds were able to again report a fixed net asset value?

GFOA would note that assets in Municipal MMFs exceeded $500 billion prior to interest rates falling to zero after the financial crisis. We believe that, absent the SEC's fluctuating NAV requirement for "non-natural persons", those investors will return to stable NAV Municipal MMFs. In addition, assets in such funds would grow, and ultimately exceed the $250 billion at the beginning of 2016, now that the Federal Reserve is allowing short-term interest rates to increase. Investors will return because they can receive a higher tax-equivalent yield by investing their cash in a Municipal MMF than from the present alternatives, such as MMFs investing in U.S. government securities or bank deposits.

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30 For example, in Ohio, here is a statute pertaining to just one community college system (Lake Mary): http://codes.ohio.gov/oac/3354:2-31-02[codes.ohio.gov].

In addition to increased borrowing costs which drive up the cost of certain public infrastructure projects, or in some cases make them unworkable, to what extent have the new rules limited the feasibility of money market funds as preferred investment and cash management tools?

Many state and local governments are subject to policies and legal restrictions permitting them to invest only in funds that have a stable share price. As a result of the 2014 Amendments, requiring a fluctuating NAV when investing in nongovernment MMFs, municipalities and other "non-natural person" investors, including hospitals, universities and businesses, have been forced out of prime money market funds and into lower yielding government funds or other alternatives from what was already a safe and highly liquid market. As we stated in testimony and previous correspondence, this has had the effect of reducing yields on cash to state and local governments, without any corresponding benefit in terms of investor protection and systemic risk.

In addition, state and local governments, and many other organizations as well, face difficult operational issues in utilizing a fluctuating NAV fund to manage cash.

According to Federal Reserve data, state and local governments hold about $190 billion of assets in money market funds. Because of the SEC rule, the only MMF options available to state and local governments are those that invest solely in U.S. government debt. They are no longer able to invest their short-term cash in prime money market funds, which have always been a safe investment providing a higher market rate of return. Over the past year, the average spread between prime and government funds has been 30 basis points. As a result, many state and local governments were prevented from taking advantage of up to $500 million in additional investment earnings that would otherwise have been available, and must be made up through reduced services or higher taxes.

One of the arguments made to justify the SEC's floating net asset value rule for money market funds was that investors do not understand that a fund with a stable share price is not guaranteed or insured by the U.S. government for purposes of their investment decision. Is that something that chief investment officers such as yourself are confused about?

Confusion about whether money market funds are government insured may be true for "retail" investors, but funds for "natural persons" are permitted to continue using amortized cost accounting to maintain a stable NAV. Only "non-natural persons" (i.e., "institutional" investors) in prime and Municipal MMFs are affected by the fluctuating NAV requirement. All municipal finance or investment officers understand the fact that money market funds are not bank-like products.

Questions for Mr. Chris Daniel, Chief Investment Officer of the City of Albuquerque, Government Finance Officers Association, on behalf of Senator Rounds:

During the Banking Committee's hearing on Legislative Proposals to Increase Access to Capital, Professor Mercer Bullard from the University of Mississippi School of Law expressed the following view on S. 1117, the Consumer Financial Choice and Capital Markets Protection Act of 2017. Could each of you please comment on Mr. Bullard's views?

Mr. Bullard. Sure. That is correct that I testified against the SEC rules primarily because money market funds had demonstrated an astonishing level of safety, especially having had two break a dollar, one not even a retail fund, over about 40 years, at the same time thousands of banks failed. But I think one of the concerns Vanguard and BlackRock have and one reason they are probably opposing this is, of course, that these rules were adopted in response to the Dodd-Frank Act, which gave banking regulators, in my view, far too much authority over what I would call risk-based markets. Banking regulation and banks are designed with the socialization of risk in mind, and when you put them in charge and the SEC realizes that FSOC is controlled by banking regulators, they will bend to banking regulators' will. So I cannot even fully blame them for what happened. But it was, I think, inevitable that there would be massive dislocation and expense. That has already occurred. Since then I think that there have been mitigating effects on the municipal business, but I think that is probably a close call. But I am concerned about that BlackRock-Vanguard concern, which is if you reintroduce floating rate NAV funds, frankly Federated will roll out a lot of funds. That will be a competitive disadvantage for the large money market fund managers. They will have to go back into the business, and then the next time a money market fund breaks, the banking regulators will have a lot less power to save the industry and, frankly, I would expect Congress to go back and end up maybe taking the same steps that dislocates the industry again.

I think the interesting point of view is we have been through this once. We do not want to go through it again. Just leave us alone.

But, you know, the free market guy in me says there is more capital that is out there looking for purchasers in a demonstrated, successful way to create essentially a cash vehicle for retail investors, and that should be an available option.

Another concern is really a specific SEC concern. One reason the Reserve Fund failed is the SEC was not monitoring the funds that had the greatest risk of failing. It also had this no-action process whereby a fund that was about to break a dollar, which had happened hundreds of times previously, was to call up an office in the SEC, and a guy picks up the phone and says, "Okay, you are fine," and because that process was fumbled by the staff, in my opinion, and because it was such an ad hoc system in the first place, that contributed to the Reserve Fund failure. It was a primary element of their defense when the founders were sued, and I think that has to be corrected.

And then, finally, I think that it is a mistake—as much as you can tell, I am probably not the biggest friend of banking regulators--to overly hamstring their Depression era authority to emergency situations, use their lending authority for nonbanks. I think that this bill would further hamstring them, and I think that is a mistake.

In both his written testimony and in response to Senator Rounds' question, Professor Bullard made several points and observations that support GFOA's position in advocating for S. 1117. First, Professor Bullard acknowledged that, during the regulatory process, he testified and advocated against the changes made by the SEC's 2014 Amendments to Rule 2a-7, which forced a fluctuating NAV for "non-natural persons", such as state and local governments, investing in prime and Municipal MMFs. In fact, what Professor Bullard predicted would happen if the SEC were to do what it did has, in fact, happened. Non-natural person investors fled prime and Municipal MMFs in 2016 and shifted their assets to U.S. government MMFs. Short-term funding markets were disrupted and remain disrupted as a result.

Second, Professor Bullard acknowledged that the real reason for the 2014 Amendments was to protect the large, systemically risky Wall Street asset managers from FSOC and Federal Reserve oversight. While GFOA does not have the expertise to evaluate the motivations of federal regulators, we would simply assert that the process and merits for a FSOC decision to designate a nonbank SIFI is an entirely separate issue from the regulation of MMFs. MMFs, and the state and local treasurers and investors that rely on MMFs, should not be sacrificed for that purpose. Congress can and should step in to fix this problem by enacting S. 1117.

Where GFOA disagrees with Professor Bullard is on his contention that the impact of the 2014 Amendments needs further study by the SEC. The consequences of the 2014 Amendments have already been studied, accurately forecast, and are understandable as a matter of economic common sense. Professor Bullard recites at length from the Federal Reserve's 2017 study of this very topic. He also references data provided by SEC Chair Clayton's 2017 letter on the issue and published SEC MMF data documenting what happened. (Pages 29-31 of Professor Bullard's written statement.)

The data from the implementation of the 2014 Amendments (in 2016) is crystal clear. Non-government MMF assets fell by 65%. A total of $1.3 *trillion* was shifted from non-government MMFs to government MMFs. (Bullard written statement at p. 29.) The data proves beyond any doubt that the impact of the 2014 Amendments was exactly as GFOA predicted, as well as Professor Bullard, during the rulemaking process and in early 2016 when the Congress was considering an earlier version of this legislation.

GFOA would also point out that the effectiveness of the SEC's 2010 Amendments to Rule 2a-7 has also been thoroughly studied by the SEC and others.[31] These studies conclude that the SEC's 2010 Amendments effectively reduced the already low risk of MMFs.

[31] SEC Division of Risk, Strategy and Financial Innovation, *Report in Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* (Nov. 30, 2012) ("SEC DERA Report"); ICI Research Perspective: *Money Market Mutual Funds, Risk, and Financial Stability in the Wake of the 2010 Reforms* (Jan. 2013).

Attachment 1

Treasury Strategies Report:
The Importance of Restoring State and Local
Government Access to Money Market Funds

Attachment referenced in answer
to Question 1 from Senator Brown

S. 1117 / H.R. 2319

The Importance of Restoring State and Local Government Access to Money Market Funds

New MMF regulations that were implemented in October 2016 are having major negative consequences for issuers and borrowers of debt held by money market funds. Specifically, Tax-Exempt MMFs (TE MMFs) are closing and assets are leaving. This is drying up a very important municipal financing conduit. Additionally, the flight of assets out of Prime MMFs is resulting in higher borrowing costs for municipalities as the pool of available capital decreases.

As TE MMFs close, municipalities have fewer buyers for their debt. Even when they are able to borrow from the remaining TE funds, they are less able to lock in rates and more subject to weekly rate resets. As we are seeing clearly in the current market today, this increases volatility and adds to their borrowing costs. If they are not able to place their debt issues with TE MMFs, only two options are available. They must turn to other lenders that have higher transaction costs / charge higher rates, or they must defer / cancel planned infrastructure, educational, healthcare and other municipal projects.

This paper will demonstrate the negative impacts on municipal financing of new MMF regulation:

- Massive amounts of assets are leaving Tax-Exempt MMFs;
- Borrowing rates for municipal borrowers have increased dramatically;

Between January 2016 and April 2018, over $110 billion left TE MMFs, a decline of more than 40%. Since TE MMFs provide significant financing to municipal borrowers, the short-term market for municipal debt is significantly smaller. The SIFMA Municipal Borrowing Index was just 1 basis point in January 2016. Now it swings wildly in a range of 100 – 180 bps. Such volatility renders this source of municipal funding much less attractive. Furthermore, the rate increase is more than double the Fed rate increase over the same period. Fed Funds rose from 50 to 175 bps - an after-tax increase equal to 75 bps.[1]

Without Tax-Exempt MMFs, municipalities are forced to use higher-cost financing sources like bank credit, or reduce their short-term capital consumption. Projects in infrastructure, healthcare, education and government services will be impacted.

TE MMF assets have declined by more than 40% since implementation of new regulations and remain near those historic low levels eighteen months later. This was not an inconsequential "temporary decline".

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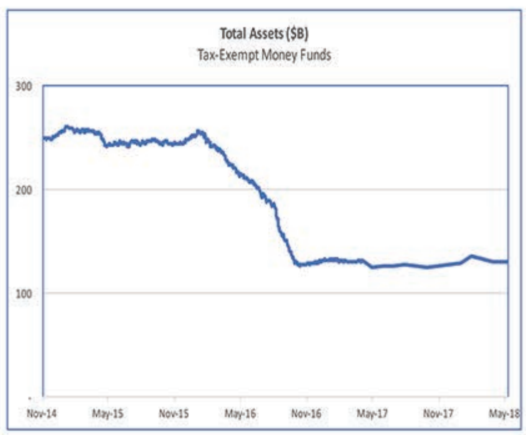
[1] A 125 bp increase at an assumed 40% tax rate. 60% of 125 bps = 75 bps. Some commentators mistakenly claim that municipal borrowing costs rose in lockstep with the Fed rate increase. That ignores the tax differential which is the key driver of the municipal market.

MMFs have historically been an important holder of short-term municipal debt. As of January 2016, they provided over $250 billion of short-term funding to municipalities by purchasing their short-term debt instruments. By April 2018, TE MMFs were at barely half that level, and were one-quarter of pre-crisis June 2008 levels.

Figure 1 shows the precipitous 2016 decline in TE MMF assets prior to the implementation of new regulations in October. Note that **TE MMF assets in April 2018 stand at $138 billion, hovering near their historic low.**

Figure 1. Tax-Exempt Money Fund Asset Levels ($B), Source: CraneData.com, Treasury Strategies (May 2018)

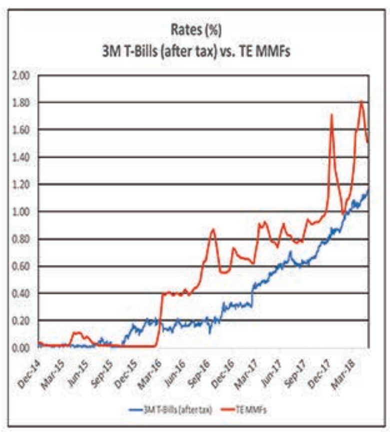


Municipal Borrowing Cost Benchmarks Have Increased Dramatically

As TE MMFs assets have fallen and numerous TE funds have closed, municipal borrowers are paying increasingly high rates to secure financing. Figure 3 shows that the TE MMF yields, a proxy for municipal borrowing costs have jumped from just 1 basis point at the beginning of 2016, to a volatile 100-180 bps range. This greatly increases borrowing costs and uncertainty for municipalities, university and hospitals. Since most debt resets weekly, borrowing costs on existing debt has increased over ten times for many borrowers.

In January, 2016, the median rate paid by municipal borrowers was 5 bps. By April, 2018, that jumped to 178 bps.

Figure 3. Comparison TE MMF yields (%) vs. 3M T-Bills (after tax), Source: Cranedata, Treasury Strategies (May 2018)



Before the new MMF regulations went into effect, municipal short term borrowing rates were consistently lower than the after-tax Fed Funds and T-Bill rates. Since then, however, municipal rates have been well above the after-tax Fed Funds rate.

Municipalities fortunate enough to continue selling VRNDs to Tax Exempt MMFs saw borrowing costs skyrocket at more than double the Fed rate increase – 170 bps vs. 75 bps after tax. Other municipalities would have to borrow from different investors, or replace their VRDNs with bank loans at much higher rates and longer maturities.

Municipal BORROWING from TEMMFs has DECREASED Dramatically

Municipalities in 48 of 50 states have lost funding from MMFs between January, 2016 and April, 2018.[2] For 21 states, the toll has been in excess of $1 billion each. Those municipalities that lost funding must now resort to higher cost bank debt, more costly long-term debt or forego projects entirely.

The following table shows the impact on a select sample of states.

Figure 4. Loss of Funding to Tax-Exempt Money Fund issuers from Select States
Source: Cranedata.com, Treasury Strategies (April 2018)

State	Principal 1/1/16 ($000,000)	Principal 4/30/18 ($000,000)	Change in Funding ($000,000)	Change in Funding %
Alabama	2,454	1,947	(507)	-21%
Arkansas	1,496	985	(511)	-34%
California	33,925	17,422	(16,503)	-49%
Colorado	4,238	2,693	(1,545)	-36%
Georgia	3,855	3,021	(835)	-22%
Hawaii	278	321	43	16%
Idaho	631	404	(227)	-36%
Indiana	4,459	1,765	(2,694)	-60%
Kansas	726	428	(298)	-41%
Louisiana	2,674	1,944	(729)	-27%
Maryland	2,800	1,413	(1,387)	-50%
Massachusetts	9,615	5,209	(4,406)	-46%
Montana	153	166	13	8%
Nebraska	932	775	(157)	-17%
Nevada	2,665	1,802	(862)	-32%
New Jersey	7,468	4,759	(2,709)	-36%
New York	38,560	22,133	(16,427)	-43%
North Carolina	4,183	1,370	(2,813)	-67%
North Dakota	544	140	(404)	-74%
Ohio	4,607	2,244	(2,363)	-51%
Pennsylvania	6,418	4,422	(1,996)	-31%
Rhode Island	498	171	(328)	-66%
South Carolina	1,927	505	(1,422)	-74%
South Dakota	351	77	(274)	-78%
Tennessee	3,119	2,284	(835)	-27%
Virginia	2,705	1,548	(1,156)	-43%
Total - All States	238,706	138,299	(100,407)	-42%

[2] Montana and Hawaii are the only two states to see an increase in funds from money market funds. Their gains were $12M and $43M respectively.

Municipal Borrowing RATES from TEMMFs have INCREASED Dramatically

Municipalities in ALL states that have been fortunate enough to continue borrowing from TEMMFs have seen funding costs increase by 1.5% to 1.9%. On a tax equivalent basis, adjusting for the fact that these securities are tax exempt, the effective rate increase ranges from 2.4% to 3.2%. During this same period, the Federal Reserve raised interest rates only 1.25%.

The following table shows the impact on a representative sample of states.

Figure 5. Change in borrowing costs to Tax-Exempt Money Fund issuers from Select States
Source: Cranedata.com, Treasury Strategies (April 2018)

State	Median 1/1/16	Median 4/30/18	Rate Increase %	Tax Equivalent Rate Increase %
Alabama	0.05%	1.77%	1.72%	2.87%
Arkansas	0.02%	1.72%	1.70%	2.83%
California	0.03%	1.76%	1.73%	2.88%
Colorado	0.03%	1.80%	1.77%	2.95%
Georgia	0.07%	1.78%	1.71%	2.85%
Hawaii	0.25%	1.78%	1.53%	2.55%
Idaho	0.03%	1.83%	1.80%	3.00%
Indiana	0.04%	1.80%	1.76%	2.93%
Kansas	0.03%	1.82%	1.79%	2.98%
Louisiana	0.03%	1.80%	1.77%	2.95%
Maryland	0.06%	1.79%	1.73%	2.88%
Massachusetts	0.05%	1.78%	1.73%	2.88%
Montana	0.03%	1.78%	1.75%	2.92%
Nebraska	0.04%	1.73%	1.69%	2.82%
Nevada	0.02%	1.78%	1.76%	2.93%
New Jersey	0.10%	2.00%	1.90%	3.17%
New York	0.30%	1.78%	1.48%	2.47%
North Carolina	0.02%	1.78%	1.76%	2.93%
North Dakota	0.05%	1.78%	1.73%	2.88%
Ohio	0.10%	1.79%	1.69%	2.82%
Pennsylvania	0.03%	1.78%	1.75%	2.92%
Rhode Island	0.02%	1.77%	1.75%	2.92%
South Carolina	0.25%	1.80%	1.55%	2.58%
South Dakota	0.03%	1.87%	1.84%	3.07%
Tennessee	0.05%	1.77%	1.72%	2.87%
Virginia	0.04%	1.77%	1.73%	2.88%
Total - All States	0.05%	1.78%	1.73%	**2.88%**
Fed Funds Rate	0.50%	1.75%	1.25%	**1.25%**

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Conclusion

New SEC rules that change how MMFs function are having many unintended consequences. One such consequence now manifesting itself is a material reduction in the short-term credit available to municipal borrowers whose debt is held by Tax-Exempt MMFs. As recently as January 2016, Tax-Exempt MMF assets exceeded $250 B. As of August 2018, they are now at $138 B, a loss of over $110 B.

These changes have also lead to a dramatic increase in municipal borrowing costs. Many municipalities have seen borrowing rates increase substantially since 2016, from a median of 5 bps to 178 bps today.

With seriously shrinking Tax-Exempt MMFs, municipalities are being forced to seek higher cost borrowing options like bank credit. Their only other alternative is to scrap projects and reduce their short-term capital consumption. Neither option bodes well for the U.S. economy and tax payer.

Some major market participants and trade associations are downplaying this significant problem by suggesting "further study". In fact, this has now been playing out in the market for nearly two full years. That's the real study. Even after two years, rising rates and a strong economy, funds have not returned, suggesting that the impact of the SEC regulations are permanent and fatal.

S. 1117 and H.R. 2319 restore Tax Exempt and Prime Money Market Funds and will facilitate the flow of capital back these important segments of the economy.

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Attachment 2

Ohio Muni Issuers

Attachment referenced in answer
to Question 1 from Senator Brown

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Columbus Gen. Oblig. Bonds Series 2012 A	12,915,000	5.00%	-		(12,915,000)
Columbus Gen. Oblig. Bonds Series 2014 A	12,000,000	5.00%	-		(12,000,000)
Franklin County Hosp. Rev. Bonds Series 2011 D, tender 8/1/2016	14,270,000	4.00%	-		(14,270,000)
HAMILTON OHIO ELEC REV	90,995,000	0.43%	-		(90,995,000)
Columbus Gen. Oblig. Bonds Series 2013 1	6,325,000	5.00%	-		(6,325,000)
Ohio Wtr. Dev. Auth. Rev. Bonds tender 5/2/2016	62,100,000	0.51%	-		(62,100,000)
City of Columbus, OH	14,500,000	2.00%	-		(14,500,000)
Ohio Higher Ed. Fac.Commission	49,500,000	0.55%	-		(49,500,000)
OHIO STATE OF GO SERIES 2009B, 5.00%	5,185,000	5.00%	-		(5,185,000)
Chillicothe City School District BAN	12,650,000	2.00%	-		(12,650,000)
Avon Lake BAN Series 2015	11,711,000	2.00%	-		(11,711,000)
Reading Cmnty. City School District BAN Series 2016, (Ohio Gen. Oblig. Guaranteed)	11,300,000	2.00%	-		(11,300,000)
UNION TWP OHIO	15,000,000	1.48%	-		(15,000,000)
Chillicothe, OH City School District , BANs , 2.000%	9,800,000	2.00%	-		(9,800,000)
Ohio Gen. Oblig. Bonds Series 2014 R	4,700,000	4.00%	-		(4,700,000)
OHIO ST	9,375,000	1.98%	-		(9,375,000)
Ohio Bldg. Auth. Bonds (Administrative Bldg. Fund Proj.) Series 2006 B	3,585,000	5.00%	-		(3,585,000)
Lucas County Gen. Oblig. BAN	11,552,000	1.50%	-		(11,552,000)
Ohio Gen. Oblig. Bonds Series 2013 B	4,190,000	4.00%	-		(4,190,000)
Ohio Gen. Oblig. Bonds (Higher Ed. Proj.) Series 2010 A	3,280,000	5.00%	-		(3,280,000)
UNIVERSITY HOSPITAL HEALTH SYSTEMSHOSPITAL RB SERIES 2013C (LOC: BARCLAYSBANK PLC), 1.75%	38,500,000	0.42%	75,000,000	1.75%	36,500,000
Ohio Gen. Oblig. Bonds Series 2012 A	4,000,000	4.00%	-		(4,000,000)
Ledyard Gen. Oblig. BAN	7,855,000	2.00%	-		(7,855,000)
Ohio Higher Edl. Facility Commission Rev. Bonds Series B5, tender 7/5/2018, CP Mode	117,500,000	0.13%	39,150,000	1.72%	(78,350,000)
Reading Cmnty. City School District BAN Series 2015, (Ohio Gen. Oblig. Guaranteed)	7,350,000	2.00%	-		(7,350,000)
Huber Heights OH BAN	14,488,700	1.00%	-		(14,488,700)
OHIO ST	2,700,000	4.95%	-		(2,700,000)
Ohio Higher Ed. Fac.Commission	24,250,000	0.55%	-		(24,250,000)
Ohio Higher Edl. Facility Commission Rev. Bonds Series B6, tender 7/5/2018, CP Mode	78,000,000	0.15%	29,600,000	1.68%	(48,400,000)
OH Air Quality Development Authority, AK Steel Project, Series 2004B	26,000,000	0.42%	-		(26,000,000)
Ohio Gen. Oblig. Bonds Series 2015 B	5,215,000	2.00%	-		(5,215,000)
North Ridgeville Gen. Oblig. BAN Series 2015	10,090,000	1.00%	-		(10,090,000)
Ohio Higher Education GO	2,000,000	5.00%	-		(2,000,000)
STATE OF OHIO	5,000,000	2.00%	-		(5,000,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Franklin County Hosp. Facilities Rev. Bonds Series 2013	2,300,000	4.00%	-		(2,300,000)
STATE OF OHIO	2,285,000	4.00%	-		(2,285,000)
OHIO ST HSG FIN AGY RSDL MTGE	22,580,000	0.40%	-		(22,580,000)
NUVEEN OHIO QUALITY INCOME MUNICIP 144A	99,800,000	0.09%	-		(99,800,000)
Akron OH Income Tax Revenue	7,000,000	1.25%	-		(7,000,000)
Ohio Gen. Oblig. Bonds Series 2015 T	1,610,000	5.00%	-		(1,610,000)
Franklin County Rev. Bonds Series 2013 OH, tender 5/1/2018	61,000,000	0.13%	56,345,000	1.27%	(4,655,000)
Newark, OH , BANs , 1.200%	6,600,000	1.20%	-		(6,600,000)
Avon, OH Water System , BANs , 1.000%	7,800,000	1.00%	-		(7,800,000)
Hamilton Station Park and Ride, (Series 2005),(Wells Fargo Bank, N.A. LOC), 1.890%	18,345,000	0.42%	16,540,000	1.89%	(1,805,000)
BELMONT CNTY OHIO	6,302,000	1.15%	-		(6,302,000)
Ohio Gen. Oblig. Bonds Series 2014 S	1,785,000	4.00%	-		(1,785,000)
Willoughby BAN Series 2015	5,700,000	1.25%	-		(5,700,000)
Springboro, OH , BANs , 1.500%	4,400,000	1.50%	-		(4,400,000)
Avon, OH , BANs , 1.250%	5,000,000	1.25%	-		(5,000,000)
Cuyahoga Falls, OH , BANs , 1.200%	5,100,000	1.20%	-		(5,100,000)
Newark, OH , BANs , 1.500%	4,000,000	1.50%	-		(4,000,000)
Ohio Gen. Oblig. Bonds (Mental Health Facilities Improvments Fund Projs.) Series 2014 A	1,500,000	4.00%	-		(1,500,000)
Lima, OH , BANs , 1.250%	4,295,000	1.25%	-		(4,295,000)
Ohio Wtr. Dev. Auth. Wtr. Poll. Cont. Rev. Bonds Series 2005	1,000,000	5.25%	-		(1,000,000)
Ohio Deutsche BankSPEARs/LIFERs Trust	16,865,000	0.31%	-		(16,865,000)
Ohio Gen. Oblig. Bonds Series 2015 B	2,610,000	2.00%	-		(2,610,000)
Hamilton County Student Hsg. Rev. (Block 3 Proj.) Series 2004, LOC Bank of New York, New York, LOC Citizens Bank of Pennsylvania VRDN	46,820,000	0.11%	22,330,000	1.73%	(24,490,000)
OHIO STATE OF GO SERIES L, 5.00%	1,000,000	5.00%	-		(1,000,000)
OHIO STATE OF GO SERIES L, 5.00%	975,000	5.00%	-		(975,000)
Ohio Gen. Oblig. Bonds Series 2014 C	4,835,000	1.00%	-		(4,835,000)
Blendon Township BAN Series 2016, (Ohio Gen. Oblig. Guaranteed)	2,250,000	2.00%	-		(2,250,000)
Ohio Mental Health Cap. Facilities Bonds (Mental Health Facilities Impt. Funds Proj.) Series 2015 A	4,320,000	1.00%	-		(4,320,000)
COLUMBUS OHIO	1,580,000	2.66%	-		(1,580,000)
Ohio State Univ. Gen. Receipts Bonds Series 2012 A	1,000,000	4.00%	-		(1,000,000)
Ohio Spl. Oblig. Bonds (Adult Correctional Bldg. Fund Proj.) Series 2015 B	1,980,000	2.00%	-		(1,980,000)
TOWNSHIP OF FAIRFIELD OH	3,650,000	1.00%	-		(3,650,000)
Ohio Gen. Oblig. Bonds Series 2012 A	910,000	4.00%	-		(910,000)
Hamilton County HealthCare Facilities Rev. Participating VRDN Series XF 10 26, (Liquidity Facility Deutsche Bank AG New York Branch)	22,050,000	0.16%	21,400,000	1.82%	(650,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Port of Greater Cincinnati Development AuthSpecial Obligation Development RB(Springdale) Series 2006 (LOC: US BANKNATIONAL ASSOCIATION), 1.80%	7,585,000	0.45%	6,480,000	1.80%	(1,105,000)
FRANKLIN MASS GO BOND ANTICIPATIONNOTE, 1.50%	2,250,000	1.50%	-		(2,250,000)
KERRVILLE TEX INDPT SCH DIST GOSERIES 2004 (GTY: TEXAS PERMANENTSCHOOL FUND PROG), 5.00%	675,000	5.00%	-		(675,000)
Williams County, OH (Community Hospital and Wellness Centers) , (Series 2008) Weekly VRDNs,(Fifth Third Bank, Cincinnati LOC), 0.100%	32,330,000	0.10%	-		(32,330,000)
Napoleon, OH , BANs , 1.250%	2,500,000	1.25%	-		(2,500,000)
Lorain County, OH , BANs , 1.750%	1,770,000	1.75%	-		(1,770,000)
LICKING CNTY OHIO	3,300,000	0.93%	-		(3,300,000)
BUTLER CNTY OHIO	5,800,000	0.52%	-		(5,800,000)
Belmont County BAN Series 2015	2,000,000	1.50%	-		(2,000,000)
Hilliard Gen. Oblig. BAN Series 2015 B	3,000,000	1.00%	-		(3,000,000)
Lebanon Gen. Oblig. BAN	3,000,000	1.00%	-		(3,000,000)
Sharonville, OH , BANs , 1.250%	2,400,000	1.25%	-		(2,400,000)
Willowick, OH , BANs , 1.000%	2,960,000	1.00%	-		(2,960,000)
MAHONING CNTY OHIO	5,320,000	0.55%	-		(5,320,000)
Johnstown, OH , BANs , 2.000%	1,450,000	2.00%	-		(1,450,000)
Ohio Juvenile Correctional Bonds (Juvenile Correctional Bldg. Fund Proj.) Series 2015 B	965,000	3.00%	-		(965,000)
Pickerington, OH , BANs , 1.250%	2,300,000	1.25%	-		(2,300,000)
OHIO STATE OF GO SERIES 2007A, 5.00%	560,000	5.00%	-		(560,000)
Tipp City, OH , BANs , 1.000%	2,800,000	1.00%	-		(2,800,000)
Central Ohio Medical Textiles	6,360,000	0.43%	-		(6,360,000)
OHIO STATE OF REV HOSPITAL(CLEVELAND CLINIC HLTH SYS OBLIGGROUP) SERIES 2008B-6, 0.10%	27,000,000	0.10%	-		(27,000,000)
CASE WESTERN RESERVE UNIVERSITY	38,500,000	0.07%	-		(38,500,000)
Cleveland Heights, OH , BANs , 1.375%	1,925,000	1.38%	-		(1,925,000)
Akron, OH , BANs , 1.150%	2,250,000	1.15%	-		(2,250,000)
Parma, OH , BANs , 1.000%	2,538,000	1.00%	-		(2,538,000)
Parma Heights, OH , BANs , 1.000%	2,520,000	1.00%	-		(2,520,000)
Avon OH GO	2,000,000	1.25%	-		(2,000,000)
Kenston OH Local School District GO	2,500,000	1.00%	-		(2,500,000)
Lake County, OH , BANs , 1.000%	2,400,000	1.00%	-		(2,400,000)
Berea, OH , BANs , 1.000%	2,360,000	1.00%	-		(2,360,000)
Ohio Gen. Oblig. Bonds Series 2014 A	1,175,000	2.00%	-		(1,175,000)
MARIETTA OHIO	2,840,000	0.83%	-		(2,840,000)
NUVEEN OHIO QUALITY INCOME MUNICIPAL FUND	23,000,000	0.10%	-		(23,000,000)
Pickerington, OH, (Series 2015) , BANs , 1.000%	2,300,000	1.00%	-		(2,300,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
County of Franklin OH	43,990,000	0.05%	-		(43,990,000)
OHIO STATE OF GO SERIES 2010C, 5.00%	430,000	5.00%	-		(430,000)
Ohio St Parks & Recreation Cap. Facilities Bonds (Park and Recreation Impt. Funds Proj.) Series 2015 A	2,095,000	1.00%	-		(2,095,000)
Columbus Gen. Oblig. Bonds Series 2013 B	500,000	4.00%	-		(500,000)
Silverton BAN (Ohio Gen. Oblig. Guaranteed)	1,600,000	1.25%	-		(1,600,000)
Allen County Hosp. Facilities Rev. Series 2012 B VRDN	99,800,000	0.02%	93,700,000	1.74%	(6,100,000)
Ohio State Air Quality Development AuthExempt Facilities RB (Andersons MarathonEthanol) Series 2007 (LOC: COBANK ACB),1.88%	49,500,000	0.04%	49,500,000	1.88%	-
Richland County, OH , BANs , 1.800%	1,000,000	1.80%	-		(1,000,000)
Butler County, OH Hospital Facilities Authority (Cincinnati Children's Hospital Medical Center) , (Series O) Weekly VRDNs,(Fifth Third Bank, Cincinnati LOC), 0.100%	16,595,000	0.10%	-		(16,595,000)
Columbus, OH City School District, Spears (Series DBE-289) Weekly VRDNs,(Deutsche Bank AG LIQ)/(GTD by Deutsche Bank AG), 0.110%	14,460,000	0.11%	-		(14,460,000)
Summit Country Day School, Inc.	2,255,000	0.70%	-		(2,255,000)
Ohio Higher Educational Facility Commission	17,500,000	0.09%	-		(17,500,000)
Parma, OH , BANs , 1.000%	1,551,000	1.00%	-		(1,551,000)
SEVEN HILLS OHIO	3,220,000	0.45%	-		(3,220,000)
Ohio Dept. of Administrative Svcs. Ctfs. of Prtn. Bonds (Administrative Knowledge Sys. Proj.) Series 2014 A	275,000	5.00%	-		(275,000)
OHIO STATE OF GO SERIES 2013B, 5.00%	265,000	5.00%	-		(265,000)
Canton, OH , BANs , 1.000%	1,300,000	1.00%	-		(1,300,000)
OHIO ST HSG FIN AGY RSDL MTGE	25,775,000	0.05%	-		(25,775,000)
NORTH RANDALL OHIO	2,308,500	0.55%	-		(2,308,500)
Ohio State University (The)	17,955,000	0.07%	-		(17,955,000)
OHIO STATE OF GO SERIES 2009C, 5.00%	250,000	5.00%	-		(250,000)
OHIO STATE OF GO SERIES 2012A, 5.00%	250,000	5.00%	-		(250,000)
OHIOHEALTH CORPORATION	11,330,000	0.11%	-		(11,330,000)
SANDUSKY OHIO	2,350,000	0.51%	-		(2,350,000)
OAKWOOD VLG OHIO	2,621,500	0.45%	-		(2,621,500)
OHIO STATE UNIVERSITY (THE)	116,400,000	0.01%	7,710,000	1.73%	(108,690,000)
Commercial Contractors, Inc., ((Series 1998)),(Manufacturers & Traders Trust Co., Buffalo, NY LOC), 0.510%	2,200,000	0.51%	-		(2,200,000)
County of Hamilton, OH ParkingSystem Revenue	11,200,000	0.10%	-		(11,200,000)
Columbus OH Regional Airport Authority Airport Revenue (FlightSafety Internation	36,870,000	0.03%	51,430,000	1.80%	14,560,000
County of Cuyahoga, OH 1.820000%	36,250,000	0.03%	37,450,000	1.82%	1,200,000
OHIO STATE OF GO SERIES 2009A, 5.00%	200,000	5.00%	-		(200,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Ohio Higher Educational Facility Commission Revenue (Case Western Reserve Univer	11,000,000	0.09%	-		(11,000,000)
Columbus Development Authority	1,990,000	0.47%	-		(1,990,000)
OHIO STATE OF GO SERIES 2010A, 4.00%	230,000	4.00%	-		(230,000)
MIAMISBURG OHIO	2,800,000	0.32%	-		(2,800,000)
Wooster, OH (West View Manor) , Health Care Facilities Revenue Bonds (Series 2003) WeeklyVRDNs,(Fifth Third Bank, Cincinnati LOC), 1.880%	4,525,000	0.19%	3,750,000	1.88%	(775,000)
OHIO ST UNIV GEN RCPTS	85,060,000	0.01%	40,100,000	1.70%	(44,960,000)
ALLEN CNTY OHIO	79,925,000	0.01%	2,900,000	1.73%	(77,025,000)
Ohio State Higher Educational Facility Commission (University Hospitals Health System, Inc.) , Floater Certificates (Series 2008-2812) Weekly VRDNs,(GTD by Morgan Stanley)/(Morgan Stanley Bank, N.A. LIQ), 0.070%	11,250,000	0.07%	-		(11,250,000)
OHIO HOUSING FINANCE AGENCY REVHOUS SINGL SERIES 2007B (LIQ:JPMORGAN CHASE BANK NA), 0.02%	39,050,000	0.02%	-		(39,050,000)
Silverton BAN (Ohio Gen. Oblig. Guaranteed)	900,000	0.85%	-		(900,000)
OHIO STATE OF GO SERIES 2005B, 5.00%	150,000	5.00%	-		(150,000)
Cuyahoga County, OH (Berea Children's Home) , (Series 2008A) Weekly VRDNs,(KeyBank, N.A. LOC), 0.130%	5,745,000	0.13%	-		(5,745,000)
County of Delaware, OH	7,355,000	0.10%	-		(7,355,000)
GRANDVIEW HEIGHTS OHIO	1,630,000	0.45%	-		(1,630,000)
Lorain, OH Port Authority	3,140,000	0.23%	2,695,000	1.96%	(445,000)
OHIO STATE UNIVERSITY	10,030,000	0.07%	-		(10,030,000)
Ohio Housing Finance Agency	33,895,000	0.02%	-		(33,895,000)
Akron, OH Metropolitan HousingAuthority	3,215,000	0.21%	-		(3,215,000)
OHIO HSG FIN AGY MTG REV	33,665,000	0.02%	-		(33,665,000)
CLARK CNTY OHIO	1,900,000	0.35%	-		(1,900,000)
Ohio State Higher Educational Facility Commission (Cleveland Clinic) , (Series 2008 B-4) DailyVRDNs,(Barclays Bank plc LIQ), 0.010%	66,500,000	0.01%	-		(66,500,000)
COLUMBUS OHIO	3,225,000	0.20%	-		(3,225,000)
Greene County, OH Hospital Facilities Revenue Authority (Med Health System) , (Series 1999A) Weekly VRDNs,(JPMorgan Chase Bank, N.A. LOC), 0.070%	9,030,000	0.07%	-		(9,030,000)
Franklin County Hosp. Rev. Series 2009 B, (Liquidity Facility Barclays Bank PLC) VRDN	63,110,000	0.01%	-		(63,110,000)
OHIO (STATE OF)	61,515,000	0.01%	1,200,000	1.75%	(60,315,000)
CLEVELAND-CUYAHOGA CNTY OHIO PORT	60,130,000	0.01%	25,895,000	1.70%	(34,235,000)
Ohio Higher Edl. Facility Commission Rev. (Case Western Reserve Univ. Proj.) Series 2008 A, LOC PNC Bank NA VRDN	60,000,000	0.01%	-		(60,000,000)
Ohio State Univ. Gen. Receipts Series 2005 B VRDN	58,960,000	0.01%	-		(58,960,000)
County of Franklin, OH	57,250,000	0.01%	-		(57,250,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
County of Pike, OH	11,355,000	0.05%	10,515,000	1.80%	(840,000)
OHIO ST AIR QUALITY DEV AUTH R	56,700,000	0.01%	-		(56,700,000)
Franklin Cnty Hospital Facilities Refunding RB(OhioHealth) Series 2009A (LIQ: BARCLAYSBANK PLC), 1.73%	55,150,000	0.01%	5,730,000	1.73%	(49,420,000)
Ohio Housing Finance Agency Residential Mortgage Revenue VRDO	25,775,000	0.02%	7,810,000	1.78%	(17,965,000)
Columbus Regional Airport Auth AirportDevelopment RB (FlightSafety) Series 2015B,1.80%	17,100,000	0.03%	22,170,000	1.80%	5,070,000
CLEVELAND OHIO ARPT SYS REV	25,595,000	0.02%	-		(25,595,000)
Ohio Housing Finance Agency Residential Mortgage Revenue VRDO	25,535,000	0.02%	-		(25,535,000)
OHIO STATE OF GO SERIES 2010A, 5.00%	100,000	5.00%	-		(100,000)
Ohio State Higher Educational Facility Commission, (Series 2006A) Weekly VRDNs,(Fifth Third Bank, Cincinnati LOC), 0.100%	4,700,000	0.10%	-		(4,700,000)
State of Ohio	46,875,000	0.01%	31,210,000	1.70%	(15,665,000)
Toledo-Lucas County, OH Port Authority (Roman Catholic Diocese of Toledo) Weekly VRDNs,(Fifth Third Bank, Cincinnati LOC), 0.100%	4,635,000	0.10%	-		(4,635,000)
City of Middletown, OH	45,200,000	0.01%	24,460,000	1.75%	(20,740,000)
COLUMBUS OHIO SWR REV	45,150,000	0.01%	-		(45,150,000)
Hamilton County, OH Hospital Facilities Authority (Children's Hospital Medical Center) Weekly VRDNs,(JPMorgan Chase Bank, N.A. LOC), 0.010%	44,235,000	0.01%	-		(44,235,000)
County of Hamilton, OH	4,400,000	0.10%	3,350,000	1.87%	(1,050,000)
Ohio Hosp. Facilities Rev. Participating VRDN Series Putters 3558,(Liquidity Facility JPMorgan Chase Bank)	21,930,000	0.02%	-		(21,930,000)
OHIO STATE UNIVERSITY (THE)	42,880,000	0.01%	180,000	1.71%	(42,700,000)
Lorain County, OH Port Authority (Brush Wellman, Inc.) , IDRB (Series 1996) Weekly VRDNs,(JPMorgan Chase Bank, N.A. LOC), 0.050%	8,305,000	0.05%	-		(8,305,000)
City of Middletown, Ohio, Hospital Facilities, Atrium Medical Center Obligated Group, Series 2008A	41,135,000	0.01%	27,225,000	1.75%	(13,910,000)
Highland County, OH Joint Hospital District, (Series 2007) Weekly VRDNs,(Fifth Third Bank, Cincinnati LOC), 0.100%	4,060,000	0.10%	-		(4,060,000)
Ohio State, General Obligation Infrastructure Improvement Bonds (Series 2003B) Weekly VRDNs, 0.010%	39,870,000	0.01%	-		(39,870,000)
Toledo-Lucas County, OH PortAuthority	4,910,000	0.08%	-		(4,910,000)
Summit County, OH PortAuthority	2,300,000	0.17%	-		(2,300,000)
OHIO ST OHS 08/21ADJUSTABLE VAR	37,535,000	0.01%	3,100,000	1.70%	(34,435,000)
Ohio State Higher Educational Facility Commission (Cleveland Clinic) , (Series 2013B-3) Daily VRDNs,(U.S. Bank, N.A. LIQ), 0.010%	36,935,000	0.01%	-		(36,935,000)
County of Wayne, OH	1,920,000	0.19%	1,345,000	1.90%	(575,000)
County of Hamilton, Ohio, St. Xavier High School Project 1.760000%	17,875,000	0.02%	6,245,000	1.76%	(11,630,000)
STATE OF OHIO	35,750,000	0.01%	-		(35,750,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Franklin County, OH Hospital Facility Authority (Nationwide Children's Hospital) , (Series 2008F) Weekly VRDNs,(PNC Bank, N.A. LIQ), 0.010%	35,035,000	0.01%	-		(35,035,000)
Toledo-Lucas County, OH Port Authority (Van Deurzen Dairy LLC) , (Series 2006) Weekly VRDNs,(Bank ofAmerica N.A. LOC), 1.870%	7,000,000	0.05%	7,000,000	1.87%	-
State of Ohio	34,700,000	0.01%	1,270,000	1.70%	(33,430,000)
State of Ohio	34,645,000	0.01%	795,000	1.74%	(33,850,000)
Hamilton County, OH Hospital Facilities Authority (The Elizabeth Gamble Deaconess Home Association) , (Series 2002A) Weekly VRDNs,(Northern Trust Co., Chicago, IL LOC), 1.760%	34,600,000	0.01%	19,550,000	1.76%	(15,050,000)
FHLMC Ohio Hsg. Fin. Agcy. Multi-family Hsg. Rev.	8,520,000	0.04%	8,435,000	1.78%	(85,000)
STATE OF OHIO	32,180,000	0.01%	2,200,000	1.70%	(29,980,000)
PORT OF GREATERCINCINNATI DEVELOPMENTAUTHORITY	1,885,000	0.17%	1,455,000	2.03%	(430,000)
Village of Cadiz, OH	1,220,000	0.26%	-		(1,220,000)
Ohio Wtr. Dev. Auth. (Waste Mgmt., Inc. Proj.) Series B, LOC Bank of America NA VRDN	15,000,000	0.02%	10,000,000	1.80%	(5,000,000)
Seneca County, OH Health Care Facilities (Good Shepherd Home) , Revenue Refunding and ImprovementBonds (Series 2003) Weekly VRDNs,(Fifth Third Bank, Cincinnati LOC), 0.080%	3,740,000	0.08%	-		(3,740,000)
Ohio State Higher Educational Facility Commission (Otterbein College) , (Series 2008B) Weekly VRDNs,(JPMorgan Chase Bank, N.A. LOC), 0.050%	5,960,000	0.05%	-		(5,960,000)
Franklin County, OH Hospital Facility Authority (U.S. Health Corp. of Columbus) , Series A WeeklyVRDNs,(Northern Trust Co., Chicago, IL LOC), 1.730%	28,665,000	0.01%	3,950,000	1.73%	(24,715,000)
Ohio Hsg. Fin. Agcy. Residential Mtg. Rev. Series 2008 B, (LiquidityFacility Fed. Home Ln. Bank, Cincinnati) VRDN	14,155,000	0.02%	-		(14,155,000)
OHIO ST TPK COMMN TPK REV	945,000	0.30%	-		(945,000)
OHIO ST HIGHER EDL FAC COMMN	27,950,000	0.01%	-		(27,950,000)
Cuyahoga County, OH Hospital Authority (The Sisters of Charity of St. Augustine Health System, Inc.) ,(Series 2000) Weekly VRDNs,(PNC Bank, N.A. LOC), 1.750%	27,800,000	0.01%	24,425,000	1.75%	(3,375,000)
GROVE CITY OHIO	9,015,000	0.03%	-		(9,015,000)
Franklin County Health Care Facilities Rev. (Presbyterian Retirement Svcs.Proj.) Series 2005 B, LOC PNC Bank NA VRDN	13,520,000	0.02%	-		(13,520,000)
Centerville (City of), Ohio (Bethany Lutheran Village Continuing Care Facility Expansion);Series 2007 B, VRD Health Care RB (LOC-PNC Bank, N.A.)	13,485,000	0.02%	-		(13,485,000)
MONTGOMERY COUNTY OHIO EDA	13,100,000	0.02%	-		(13,100,000)
Columbus Gen. Oblig. Participating VRDN Series Putters 2365, (Liquidity Facility JPMorgan Chase Bank)	8,720,000	0.03%	-		(8,720,000)
Franklin County, OH Hospital Facility Authority (Nationwide Children's Hospital) , (Series 2008D) Weekly VRDNs,(Bank of New York Mellon LIQ), 0.010%	25,120,000	0.01%	-		(25,120,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Ohio Air Quality Development Authority, Oio Valley Electric Corporation Project, Series 2009D	25,000,000	0.01%	13,880,000	1.67%	(11,120,000)
OHIO STATE UNIVERSITY (THE)	25,000,000	0.01%	1,800,000	1.70%	(23,200,000)
Ohio State University (The)	25,000,000	0.01%	-		(25,000,000)
FRANKLIN CNTY OHIO HOSP FACS R	24,600,000	0.01%	14,150,000	1.70%	(10,450,000)
Ohio Higher Educational Facility CommissionRB (Case Western Reserve Univ) Series 2006(LOC: STATE STREET BANK AND TRUSTCOMPANY), 1.79%	24,380,000	0.01%	24,380,000	1.79%	-
BLUE ASH OH ECON DEV REVENUE	12,155,000	0.02%	11,515,000	1.76%	(640,000)
Marion Cnty M/F Housing RB (Avalon Lakes)Series 2006 (LOC: FEDERAL HOME LOANBANKS), 1.83%	8,090,000	0.03%	7,910,000	1.83%	(180,000)
Cleveland-Cuyahoga County, OH Port Authority 1.780000%	23,900,000	0.01%	6,625,000	1.78%	(17,275,000)
SALEM OH CIVIC FAC REV S(LOC; PNC Bank NA)	5,955,000	0.04%	5,060,000	1.80%	(895,000)
Montgomery Cnty M/F Housing RB (CambridgeCommons Apts) Series 2006A (LOC: FEDERALHOME LOAN BANKS), 1.78%	7,920,000	0.03%	7,920,000	1.78%	-
Toledo-Lucas County Port Auth. (St. Francis De Salle High School Proj.) Series 2004 D, LOC Fifth Third Bank, Cincinnati VRDN	1,975,000	0.12%	-		(1,975,000)
Ohio State University General Receipts Revenue TOB VRDO	5,750,000	0.04%	-		(5,750,000)
Ohio State University General Receipts Revenue TOB VRDO	5,750,000	0.04%	-		(5,750,000)
HAMILTON CNTY OH HOSP FACS REVENUE	22,900,000	0.01%	11,400,000	1.75%	(11,500,000)
Mahoning County, OH IDA (Modern Builders Supply, Inc.) , (Series 1999) Weekly VRDNs,(PNC Bank, N.A. LOC), 1.020%	2,000,000	0.11%	-		(2,000,000)
Summit County, OH IDA (AESCO, Inc.) , (Series 2001) Weekly VRDNs,(FirstMerit Bank, N.A. LOC), 1.870%	1,450,000	0.15%	995,000	1.87%	(455,000)
BRECKSVILLE OHIO	620,000	0.35%	-		(620,000)
Stark County, OH IndustrialDevelopment	1,250,000	0.17%	-		(1,250,000)
FRANKLIN HLTH-VAR-B-	10,540,000	0.02%	-		(10,540,000)
OHIO STATE	1,750,000	0.12%	-		(1,750,000)
Tuscarawascnty Oh Port Auth I	3,345,000	0.06%	-		(3,345,000)
OHIO STATE OF REV STATE SERIES 2013A,2.00%	100,000	2.00%	-		(100,000)
STARK CNTY OH PORT AUTH.(LOC; JPMorgan Chase Bank)	2,485,000	0.08%	1,205,000	1.78%	(1,280,000)
Cuyahoga County, OH (The Health Museum of Cleveland) , (Series 2002) Weekly VRDNs,(PNC Bank, N.A. LOC), 0.020%	9,940,000	0.02%	-		(9,940,000)
OHIO ST AIR QUALITY DEV AUTH REV	19,850,000	0.01%	-		(19,850,000)
Highland County, OH JointTownship Hospital District	1,650,000	0.12%	1,240,000	1.88%	(410,000)
Ohio Hsg. Fin. Agcy. Mtg. Rev. (Mtg.-Backed Securities Prog.) Series F,(Liquidity Facility Fed. Home Ln. Bank, Cincinnati) VRDN	9,890,000	0.02%	-		(9,890,000)
UNIVERSITY TOLEDO OHIO GEN RECPT	315,000	0.61%	-		(315,000)
Ohio Air Quality Dev. Auth. Rev. (Ohio Valley Elec. Corp. Proj.) Series 2009 B, LOC Bank of Nova Scotia VRDN	18,900,000	0.01%	-		(18,900,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Parma, OH (Catholic Charites) , (Series 2008) Weekly VRDNs,(Citizens Bank, N.A., Providence LOC), 0.120%	1,575,000	0.12%	-		(1,575,000)
Columbus OH Regional Airport Authority Airport Revenue (OASBO Expanded Asset Pro	18,665,000	0.01%	11,220,000	1.74%	(7,445,000)
CUYAHOGA COUNTY AIRPORT(LOC; U.S. Bank NA)	1,865,000	0.10%	1,450,000	1.99%	(415,000)
Cleveland Cnty Industrial Facilities & PollutionControl Financing Auth Recreational FacilitiesRB (Cleveland Cnty Family YMCA) Series 2007(LOC: BRANCH BANKING AND TRUSTCOMPANY), 1.77%	9,215,000	0.02%	8,485,000	1.77%	(730,000)
HAMILTON CNTY OHIO HOSP FACS REV	17,945,000	0.01%	-		(17,945,000)
Ohio Hsg. Fin. Agcy. Mtg. Rev. (Mtg.-Backed Securities Prog.) Series B,(Liquidity Facility Fed. Home Ln. Bank, Cincinnati) VRDN	8,910,000	0.02%	-		(8,910,000)
OHIO ST HIGHER EDL FAC REV	8,810,000	0.02%	-		(8,810,000)
Medina County, OH (Mack Industries, Inc.) , (Series 1998) Weekly VRDNs,(JPMorgan Chase Bank, N.A. LOC), 0.160%	1,100,000	0.16%	-		(1,100,000)
Montgomery County, OH (Kroger Co.) , (Series 2005) Weekly VRDNs,(Bank of Nova Scotia, Toronto LOC), 0.060%	2,925,000	0.06%	-		(2,925,000)
CUYAHOGA CNTY OHIO IDR(LOC; PNC Bank NA)	1,595,000	0.11%	1,325,000	1.83%	(270,000)
Ohio State University Revenue	17,500,000	0.01%	-		(17,500,000)
Ohio State Higher Educational Facility Commission (John Carroll University, OH) , (Series A) Weekly VRDNs,(JPMorgan Chase Bank, N.A. LOC), 0.920%	8,700,000	0.02%	-		(8,700,000)
Ohio Hsg. Fin. Agcy. Mtg. Rev. Series 2004 D, (Liquidity Facility Fed.Home Ln. Bank, Cincinnati) VRDN	8,645,000	0.02%	-		(8,645,000)
East Liverpool OH Hosp Revenue Adj-East Liverpool	17,165,000	0.01%	-		(17,165,000)
Hamilton County Hosp. Facilities Rev. (Children's Hosp. Med. Ctr. Proj.)Series 1997 A, LOC PNC Bank NA VRDN	16,900,000	0.01%	-		(16,900,000)
CUYAHOGA CNTY OHIO IDR(LOC; PNC Bank NA)	1,525,000	0.11%	980,000	1.83%	(545,000)
CLEVELAND-CUYAHOGA CNTY OH PORT AUTH CUL	16,750,000	0.01%	20,000,000	1.75%	3,250,000
MONTGOMERY CNTY OHIO REV	16,210,000	0.01%	-		(16,210,000)
Cleveland-Cuyahoga County OH Port Authority Revenue (Cleveland Museum of Art Pro	15,900,000	0.01%	18,000,000	1.75%	2,100,000
COLUMBUS OHIO REGL ARPT AUTH CAP FDG REV	15,865,000	0.01%	12,980,000	1.74%	(2,885,000)
OHIO ST	565,000	0.28%	-		(565,000)
Ohio St Univ Variable-Ser B-1	15,500,000	0.01%	-		(15,500,000)
HAMILTON OHIO MULTIFAMILY REV	1,026,000	0.15%	-		(1,026,000)
Hamilton County, OH Hospital Facilities Authority (Children's Hospital Medical Center) , (Series 2007M) Weekly VRDNs,(JPMorgan Chase Bank, N.A. LOC), 0.010%	15,315,000	0.01%	-		(15,315,000)
ALLEN CNTY OHIO REV HOSPITAL (MERCYHEALTH (OHIO)) SERIES 2012A (LIQ:MORGAN STANLEY BANK NA), 0.02%	7,500,000	0.02%	-		(7,500,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Ohio Hsg. Fin. Agcy. Residential Mtg. Rev. (Mtg.-Backed Securities Prog.) Series 2008 D, (Liquidity Facility Fed. Home Ln. Bank, Cincinnati) VRDN	15,000,000	0.01%	-		(15,000,000)
MONTGOMERY CNTY OHIO REV	14,900,000	0.01%	-		(14,900,000)
County of Trumbull, OH	860,000	0.17%	-		(860,000)
Ohio State University, (Series 1997) Weekly VRDNs, 0.010%	14,260,000	0.01%	-		(14,260,000)
ATHENS CNTY OHIO PORT AUTH HSG	14,085,000	0.01%	-		(14,085,000)
Ohio State Economic Development Revenue 1.760000%	4,625,000	0.03%	1,060,000	1.76%	(3,565,000)
COLUMBUS OHIO	13,810,000	0.01%	-		(13,810,000)
Ohio Hsg. Fin. Agcy. Residential Mtg. Rev. Series 2008 H, (Liquidity Facility Fed. Home Ln. Bank, Cincinnati) VRDN	6,895,000	0.02%	-		(6,895,000)
LORAIN CNTY OHIO IDR(LOC; PNC Bank NA)	1,240,000	0.11%	845,000	1.83%	(395,000)
Franklin County Health Care Facilities Rev. (Friendship Village of Dublin, Ohio, Inc. Proj.) Series 2004 A, LOC PNC Bank NA VRDN	6,675,000	0.02%	-		(6,675,000)
Wood County Commission Solid Waste Disp. Rev. (Waste Mgmt., Inc. Proj.) Series A, LOC Bank of America NA VRDN	6,580,000	0.02%	6,580,000	1.80%	-
Franklin (County of), Ohio (Golf Pointe Apartments); Series 2000 B, VRD MFH RB (LOC-FHLB of Indianapolis)	435,000	0.30%	-		(435,000)
Village of Indian Hill Econ. Dev. Rev. (Cincinnati Country Day School Proj.) Series 1999, LOC PNC Bank NA VRDN	4,345,000	0.03%	-		(4,345,000)
Summit County, OH IDA (Waldonia Investment) , (Series 1998(Weekly VRDNs,(KeyBank, N.A. LOC),1.890%	750,000	0.17%	100,000	1.89%	(650,000)
CLEVELAND CLINIC	6,245,000	0.02%	-		(6,245,000)
Ohio JPMorgan Chase Putters/Drivers Trust	6,225,000	0.02%	-		(6,225,000)
Franklin Cnty Hospital Facilities RB(OhioHealth) Series 2015 (LIQ: TORONTO-DOMINION BANK/THE), 1.79%	6,000,000	0.02%	12,000,000	1.79%	6,000,000
Columbus Gen. Oblig. Participating VRDN Series Clipper 08 2, (LiquidityFacility State Street Bank & Trust Co., Boston)	11,985,000	0.01%	-		(11,985,000)
CLEVELAND OH ARPT SYS REVENUE	5,975,000	0.02%	5,175,000	1.74%	(800,000)
Ohio Hosp. Facilities Rev. Participating VRDN Series Putters 3552,(Liquidity Facility JPMorgan Chase Bank)	5,940,000	0.02%	-		(5,940,000)
TOLEDO-LUCAS CNTY OHIO PORT AUTHREV TRANSPORTATION (BERKSHIREHATHAWAY INC) SERIES 1998-1, 0.02%	5,750,000	0.02%	-		(5,750,000)
Ohio Infrastructure Improvement GO VRDO	11,330,000	0.01%	1,395,000	1.70%	(9,935,000)
Franklin County Hosp. Rev. (U.S. Health Corp. of Columbus Proj.) Series 1996 B, LOC Northern Trust Co. VRDN	11,180,000	0.01%	-		(11,180,000)
OHIO ST UNIV GEN RCPTS	11,000,000	0.01%	-		(11,000,000)
Ohio Air Quality Development Authority	11,000,000	0.01%	-		(11,000,000)
Lake County, OH (Apsco Properties Ltd.) , (Series 1996) Weekly VRDNs,(FirstMerit Bank, N.A. LOC), 1.070%	730,000	0.15%	-		(730,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Lorain (County of), Ohio Port Authority (St. Ignatius High School); Series 2008, VRD Educational Facilities RB (LOC-U.S. Bank, N.A.)	3,590,000	0.03%	2,450,000	1.76%	(1,140,000)
County of Pike, OH	2,095,000	0.05%	-		(2,095,000)
Franklin County, OH Hospital Facility Authority (OhioHealth Corp,) , Barclays Floater Certificates (Series 2011-21B) Weekly VRDNs,(Barclays Bank plc LIQ), 0.030%	3,480,000	0.03%	-		(3,480,000)
Montgomery County OH Revenue (Miami Valley Hospital) VRDO	9,900,000	0.01%	-		(9,900,000)
Franklin County Hosp. Rev. (OhioHealth Corp. Proj.) Series D, LOC Northern Trust Co. VRDN	9,670,000	0.01%	-		(9,670,000)
Cincinnati & Hamilton County,OH Port Authority	3,100,000	0.03%	2,500,000	1.62%	(600,000)
Summit County, OH IDA (Wintek Ltd.) , Variable Rate IDRB's (Series 1998A) Weekly VRDNs,(FirstMeritBank, N.A. LOC), 1.870%	610,000	0.15%	320,000	1.87%	(290,000)
OHIO ST HIGHER EDL FAC COMMN	9,100,000	0.01%	24,250,000	1.61%	15,150,000
Strongsville, OH (Monarch Engraving, Inc.) Weekly VRDNs,(FirstMerit Bank, N.A. LOC), 0.410%	220,000	0.41%	-		(220,000)
Ohio Higher Educational Facility CommissionHospital RB (Cleveland Clinic) Series 2008A(LIQ: JPMORGAN CHASE BANK NA), 1.78%	4,500,000	0.02%	36,675,000	1.78%	32,175,000
City of Solon OH	815,000	0.11%	-		(815,000)
Ohio Water Development Authority (Timken Co.) , (Series 2001) Weekly VRDNs,(Northern Trust Co., Chicago, IL LOC), 0.010%	8,900,000	0.01%	-		(8,900,000)
CLEVELAND-CUYAHOGA CNTY OHIO PORT	8,715,000	0.01%	600,000	1.76%	(8,115,000)
Ohio Air Quality Dev. Auth. Rev. (TimkenSteel Proj.) Series 2003, LOC JPMorgan Chase Bank VRDN	8,500,000	0.01%	-		(8,500,000)
Columbus OH Regional Airport Authority Airport Revenue (OASBO Expanded Asset Pro	8,445,000	0.01%	3,815,000	1.74%	(4,630,000)
Butler Cnty OH Hlthcare Facs R Adj-Colonial Sr Svc	2,550,000	0.03%	-		(2,550,000)
Cleveland-Cuyahoga County OH Port Authority Revenue (Cleveland Museum of Art Pro	7,400,000	0.01%	7,900,000	1.76%	500,000
ROSS CNTY OHIO HOSP REV	3,700,000	0.02%	-		(3,700,000)
OHIO ST WTR DEV AUTH REV	210,000	0.35%	-		(210,000)
OHIO STATE UNIVERSITY/THE	7,200,000	0.01%	-		(7,200,000)
BUTLER CNTY OHIO CAP FDG REV	7,035,000	0.01%	-		(7,035,000)
Montgomery County OH Revenue (Miami Valley Hospital) TOB VRDO	3,500,000	0.02%	-		(3,500,000)
Franklin County OH Hospital Facilities Revenue (Doctors OhioHealth Corp.) VRDO	6,815,000	0.01%	14,955,000	1.73%	8,140,000
Cincinnati Wtr. Sys. Rev. Participating VRDN Series MS 3280, (Liquidity Facility Morgan Stanley Bank, West Valley City Utah)	3,330,000	0.02%	3,750,000	1.78%	420,000
Hamilton Cnty OH Econ Dev Reve Var-Cincinnati Symp	1,525,000	0.04%	-		(1,525,000)
PORT OF GREATERCINCINNATI DEVELOPMENTAUTHORITY	350,000	0.17%	280,000	2.03%	(70,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Hamilton County HealthCare Facilities Rev. (The Children's Home of Cincinnati Proj.) Series 2009, LOC U.S. Bank NA, Cincinnati VRDN	2,975,000	0.02%	-		(2,975,000)
Hamilton Cnty OH Hlth Care Fac Var-Childrens Home	2,920,000	0.02%	-		(2,920,000)
Lorain County, OH (Ohio Metallurgical Service, Inc.) Weekly VRDNs,(FirstMerit Bank, N.A. LOC), 0.150%	385,000	0.15%	-		(385,000)
Hamilton, OH Multi-Family Housing (Pedcor Investments-2003-LIX LP) , (Series 2003B: Knollwood Crossing II Apartments) Weekly VRDNs,(Federal Home Loan Bank of Indianapolis LOC), 1.060%	360,000	0.16%	-		(360,000)
Ohio JPMorgan Chase Putters/Drivers Trust	2,845,000	0.02%	-		(2,845,000)
Columbus OH Regional Airport Authority Revenue (Pooled Financing Program) VRDO	5,550,000	0.01%	6,475,000	1.74%	925,000
OHIO ST TPK COMMN TPK REV	145,000	0.38%	-		(145,000)
FRANKLIN CNTY OHIO IDR(LOC; PNC Bank NA)	135,000	0.38%	-		(135,000)
BUTLER CNTY OH REV LAKOT(LOC; PNC Bank NA)	1,700,000	0.03%	1,500,000	1.81%	(200,000)
FRANKLIN CNTY OHIO HOSP REV	4,900,000	0.01%	-		(4,900,000)
Ohio Hsg. Fin. Agcy. Multi-family Hsg. Rev. (Pedcor Invts. Willow Lake Apts. Proj.) Series B, LOC Fed. Home Ln. Bank, Indianapolis VRDN	310,000	0.15%	-		(310,000)
Hamilton Cnty OH Econ Dev Reve Var-Samuel W Bell H	1,460,000	0.03%	-		(1,460,000)
CUYAHOGA OHIO CMNTY COLLEGE DI	100,000	0.40%	-		(100,000)
Ohio GO VRDO	2,885,000	0.01%	-		(2,885,000)
CLEVELAND-CUYAHOGA CNTY OHIO PORT	2,815,000	0.01%	1,150,000	1.70%	(1,665,000)
Coshocton, OH (Coshocton County Memorial Hospital) , (Series 1999) Weekly VRDNs,(JPMorgan Chase Bank, N.A. LOC), 0.010%	2,800,000	0.01%	-		(2,800,000)
County of Geauga OH	605,000	0.04%	-		(605,000)
HAMILTON CNTY OHIO HOSP(LOC; PNC Bank NA)	600,000	0.04%	2,750,000	1.80%	2,150,000
Ohio State Air Quality Development Authority (First Energy Corp.) , (Series 2008-C) Daily VRDNs,(Bank of Nova Scotia, Toronto LOC), 0.010%	2,000,000	0.01%	-		(2,000,000)
Ohio State Water Development Authority Pollution Control Facilities (First Energy Corp.) , (Series 2008-B) Daily VRDNs,(Bank of Nova Scotia, Toronto LOC), 0.010%	1,905,000	0.01%	-		(1,905,000)
Wood County Indl. Dev. Rev. (CMC Group Proj.) Series 2001, LOC PNC Bank NA VRDN	120,000	0.14%	-		(120,000)
Franklin County, OH Hospital Facility Authority (Nationwide Children's Hospital) , (Series 2008C) Weekly VRDNs,(JPMorgan Chase Bank, N.A. LIQ), 0.010%	1,105,000	0.01%	-		(1,105,000)
Summit County, OH IDA (Fomo Products, Inc.) , Adjustable Rate IDRB's (Series 1996) Weekly VRDNs,(FirstMerit Bank, N.A. LOC), 0.150%	70,000	0.15%	-		(70,000)
Montgomery County, OH (Miami Valley Hospital) , (Series 2008B) Daily VRDNs,(Barclays Bank plc LIQ), 0.010%	1,000,000	0.01%	-		(1,000,000)

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Ohio Hsg. Fin. Agcy. Mtg. Rev. Participating VRDN Series Merlots 06 A2, (Liquidity Facility Wells Fargo Bank NA)	100,000	0.08%	-		(100,000)
Middletown Hosp. Facilities Rev. Participating VRDN Series Floaters 00 31 44, (Liquidity Facility Barclays Bank PLC)	-		78,205,000	1.93%	78,205,000
STATE OF OHIO	-		67,655,000	1.71%	67,655,000
Ohio Higher Edl. Facility Commission Rev. Participating VRDN Series 2017, (Liquidity Facility Barclays Bank PLC)	-		49,520,000	1.93%	49,520,000
HAMILTON CNTY OHIO HOSP FACS REV	-		42,160,000	1.73%	42,160,000
Brunswick Ohio City School District BAN Series 2018	-		25,705,000	2.50%	25,705,000
Lucas County, OH (ProMedica Healthcare Obligated Group) , Golden Blue (Series 2018-002)VRENs,(Barclays Bank plc LIQ)/(Barclays Bank plc LOC), 2.000%	-		31,000,000	2.00%	31,000,000
Ohio Hosp. Facilities Rev. Participating VRDN Series 2016 ZF0355, (Liquidity Facility JPMorgan Chase Bank)	-		32,930,000	1.78%	32,930,000
Akron, OH , BANs , 3.000%	-		17,500,000	3.00%	17,500,000
Ohio Higher Educational Facility Commission Revenue (Cleveland Clinic Health Sys	-		37,000,000	1.32%	37,000,000
FRANKLIN CNTY OHIO HOSP FACS R	-		27,140,000	1.73%	27,140,000
Summit Gen. Oblig. BAN Series 2018	-		14,702,000	3.00%	14,702,000
HAMILTON CNTY OHIO HOSP FACS REV	-		24,030,000	1.74%	24,030,000
Ohio Higher Educational Facility CommissionHospital RB (Cleveland Clinic) Series 2008B5,1.30%	-		31,145,000	1.30%	31,145,000
Ohio HFA Residential Mortgage RB Series2016G (LIQ: FEDERAL HOME LOAN BANKS),1.80%	-		21,820,000	1.80%	21,820,000
Lakewood OH Income Tax Revenue	-		15,100,000	2.50%	15,100,000
Ohio Higher Educational Facility Commission Revenue (Case Western Reserve Univer	-		30,000,000	1.22%	30,000,000
Warren County OH Port Authority Revenue (Corridor 75 Park Project)	-		5,085,000	7.00%	5,085,000
OHIO ST SPL OBLG	-		16,800,000	1.86%	16,800,000
Union Township OH BAN	-		15,305,000	2.00%	15,305,000
Ohio Hsg. Fin. Agcy. Residential Mtg. Rev. Series 2016 H, (Liquidity Facility Fed. Home Ln. Bank, Cincinnati) VRDN	-		15,600,000	1.80%	15,600,000
Delaware, OH , BANs , 3.000%	-		9,265,000	3.00%	9,265,000
MONTGOMERYCNTY OH REVENUE	-		13,565,000	1.97%	13,565,000
Lucas County Gen. Oblig. Bonds Series 2016 26, tender 5/24/2018, (Liquidity Facility U.S. Bank NA, Cincinnati)	-		13,930,000	1.90%	13,930,000
STATE OF OHIO G.O. INFRASTRUCTURE IMPRV	-		15,375,000	1.70%	15,375,000
Ohio State University General Receipts Revenue CP	-		15,990,000	1.60%	15,990,000
Ohio Housing Finance Agency Residential Mortgage Revenue VRDO	-		12,940,000	1.82%	12,940,000

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Lakewood City School District Bonds Series Solar 0067, tender 5/24/2018, (Liquidity Facility U.S. Bank NA, Cincinnati)	-		12,115,000	1.90%	12,115,000
Cleveland Clinic Health System Obligated Group Revenue	-		13,000,000	1.75%	13,000,000
Hamilton County OH Sewer System Revenue TOB VRDO	-		12,750,000	1.78%	12,750,000
Wayne Local School District BAN Series 2017	-		9,000,000	2.50%	9,000,000
Ohio State University General Receipts Revenue CP	-		17,180,000	1.28%	17,180,000
Franklin County OH Hospital Facilities Revenue (OhioHealth Corp.) VRDO	-		12,675,000	1.73%	12,675,000
Ohio Higher Educational Facility Commission Revenue (Cleveland Clinic Health Sys	-		17,495,000	1.23%	17,495,000
Big Walnut Local School District BAN Series 2017	-		8,000,000	2.63%	8,000,000
Southwest Local School District BAN Series 2017	-		8,400,000	2.50%	8,400,000
Ohio State University General Receipts Revenue CP	-		16,630,000	1.15%	16,630,000
Independence Gen. Oblig. BAN Series 2017	-		9,400,000	2.00%	9,400,000
Hamilton County HealthCare Facilities Rev. Participating VRDN Series XF 10 50, (Liquidity Facility Deutsche Bank AG New York Branch)	-		10,370,000	1.81%	10,370,000
Springfield Gen. Oblig. BAN Series 2018, (Ohio Gen. Oblig. Guaranteed)	-		7,500,000	2.50%	7,500,000
Tipp City, OH, (Series A) , BANs , 2.125%	-		8,643,000	2.13%	8,643,000
Shaker Heights City School District BAN Series 2017	-		6,000,000	3.00%	6,000,000
Ohio Gen. Oblig. Bonds Series 2014 B	-		3,500,000	5.00%	3,500,000
Avon, OH Water System , BANs , 2.375%	-		7,250,000	2.38%	7,250,000
CITY OF FAIRBORN, OH	-		6,887,000	2.25%	6,887,000
Highland Local School District BAN Series 2017	-		5,900,000	2.50%	5,900,000
Toledo OH Waterworks Revenue TOB VRDO	-		8,000,000	1.83%	8,000,000
Geauga County Ohio Pub. Libr BAN Series 2017, (Ohio Gen. Oblig. Guaranteed)	-		6,000,000	2.25%	6,000,000
Mason OH City School District BAN	-		4,360,000	3.00%	4,360,000
Ohio Hsg. Fin. Agcy. Residential Mtg. Rev. Series 2016 I, (Liquidity Facility Fed. Home Ln. Bank, Cincinnati) VRDN	-		7,215,000	1.80%	7,215,000
Lucas County Gen. Oblig. BAN Series 2017	-		6,250,000	2.00%	6,250,000
Mason Gen. Oblig. BAN Series 2016	-		5,000,000	2.50%	5,000,000
Franklin County OH Hospital Facilities Revenue (OhioHealth Corp.) TOB VRDO	-		6,830,000	1.79%	6,830,000
Northeast OH Regional Sewer District Revenue (Wastewater Revenue Improvement) TO	-		6,800,000	1.78%	6,800,000
Ohio Hosp. Facilities Rev. Participating VRDN Series XM 05 20, (Liquidity Facility JPMorgan Chase Bank)	-		6,750,000	1.78%	6,750,000
Ohio Higher Educational Facility CommissionHospital RB (Cleveland Clinic) Series 2009B1(LIQ: JPMORGAN CHASE BANK NA), 1.78%	-		6,675,000	1.78%	6,675,000
BEREA OHIO	-		7,800,900	1.52%	7,800,900

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Northeast Ohio Regional Sewer DistrictWastewater Refunding RB Series 2017 (LIQ:TORONTO-DOMINION BANK/THE), 1.78%	-		6,335,000	1.78%	6,335,000
Ohio Hosp. Facilities Rev. Participating VRDN Series 16 ZF0354, (Liquidity Facility JPMorgan Chase Bank)	-		6,250,000	1.78%	6,250,000
OHIO HIGHER ED FAC CASE	-		7,940,000	1.38%	7,940,000
Ohio Higher Educational Facility Commission	-		8,300,000	1.32%	8,300,000
Springfield Township Gen. Oblig. BAN	-		4,700,000	2.25%	4,700,000
Allen County Hosp. Facilities Rev. Participating VRDN Series Floaters XF 25 16, (Liquidity Facility Citibank NA)	-		5,640,000	1.85%	5,640,000
Ohio State University General Receipts Revenue TOB VRDO	-		5,750,000	1.81%	5,750,000
Ohio State University General Receipts Revenue TOB VRDO	-		5,750,000	1.81%	5,750,000
Marion Gen. Oblig. BAN Series 2017, (Ohio Gen. Oblig. Guaranteed)	-		4,700,000	2.00%	4,700,000
Elyria Gen. Oblig. BAN Series 2017, (Ohio Gen. Oblig. Guaranteed)	-		3,000,000	3.00%	3,000,000
North Ridgeville Gen. Oblig. BAN Series 2017	-		4,500,000	2.00%	4,500,000
Kent OH BAN	-		4,495,000	2.00%	4,495,000
Cincinnati OH City School District GO TOB VRDO	-		5,000,000	1.78%	5,000,000
Ohio Higher Educational Facility Commission	-		5,000,000	1.75%	5,000,000
Ohio GO VRDO	-		4,885,000	1.70%	4,885,000
Mayfield Heights Gen. Oblig. BAN Series 2018, (Ohio Gen. Oblig. Guaranteed)	-		3,300,000	2.50%	3,300,000
Franklin County Hosp. Facilities Rev. Participating VRDN Series 16 XL0004, (Liquidity Facility Barclays Bank PLC)	-		4,480,000	1.79%	4,480,000
OHIO ST HOSP FAC REV ACTING BY AND 144A	-		4,340,000	1.78%	4,340,000
Ohio HFA Residential Mortgage RB Series2016F (LIQ: FEDERAL HOME LOAN BANKS),1.80%	-		4,205,000	1.80%	4,205,000
Franklin County Gen. Oblig. BAN Series 2017	-		3,300,000	2.13%	3,300,000
Wayne County Ohio BD BAN Series 2017	-		3,500,000	2.00%	3,500,000
Ohio Higher Edl. Facility Commission Rev. Participating VRDN Series XG 00 69, (Liquidity Facility Deutsche Bank AG New York Branch)	-		3,750,000	1.81%	3,750,000
Licking County BAN Series 2018	-		2,100,000	3.00%	2,100,000
Ohio Housing Finance Agency Residential Mortgage Revenue VRDO	-		3,500,000	1.77%	3,500,000
Belmont County BAN Series 2017	-		3,000,000	2.00%	3,000,000
Franklin Cnty RB (St George Commons Apts)Series 2007 (LOC: FEDERAL NATIONALMORTGAGE ASSOCIATION), 1.87%	-		3,100,000	1.87%	3,100,000
Avon Gen. Oblig. BAN Series 2018	-		2,400,000	2.38%	2,400,000
Powell Gen. Oblig. BAN Series 2017	-		2,265,000	2.50%	2,265,000
OHIO ST UNIV OHSHGR 12/39ADJUSTABLE VAR	-		3,050,000	1.70%	3,050,000
Belmont County BAN Series 2017	-		2,500,000	2.00%	2,500,000
Licking County BAN Series 2017	-		2,400,000	2.00%	2,400,000

Ohio Muni Issuers

Holding Name	Principal Jan 31 16	Coupon Jan 31 16	Principal Apr 30 18	Coupon Apr 30 18	$$$ Change
Pickerington Gen. Oblig. BAN Series 2018	-		2,000,000	2.38%	2,000,000
Ohio Hosp. Facilities Rev. Bonds Series 2009 B, (Pre-Refunded to 1/1/2019 @ 100)	-		1,000,000	4.75%	1,000,000
Canal Fulton BAN Series 2018, (Ohio Gen. Oblig. Guaranteed)	-		1,730,000	2.50%	1,730,000
UHRICHSVILLE OHIO	-		2,555,000	1.69%	2,555,000
VILLAGE OF CUYAHOGAHEIGHTS, OH	-		2,000,000	1.63%	2,000,000
AMERICAN MUN PWR-OHIO INC	-		2,072,000	1.52%	2,072,000
Southwest Local School District Bonds Series 2018 B	-		1,000,000	3.00%	1,000,000
Euclid Gen. Oblig. BAN Series 2018, (Ohio Gen. Oblig. Guaranteed)	-		1,001,000	2.75%	1,001,000
HAMILTON CNTY OH ECON DE(LOC; PNC Bank NA)	-		1,475,000	1.85%	1,475,000
HAMILTON TWP MERCER CNTY	-		550,000	3.91%	550,000
AMERICAN MUN PWR-OHIO INC	-		1,595,000	1.22%	1,595,000
AMERICAN MUN PWR-OHIO INC	-		904,000	2.04%	904,000
Walton Hills BD Anticipation BAN Series 2017, (Ohio Gen. Oblig. Guaranteed)	-		860,000	2.00%	860,000
OHIO STATE UNIVERSITY (THE)	-		1,000,000	1.71%	1,000,000
KIRTLAND OHIO	-		1,040,000	1.25%	1,040,000
STARK CNTY OH PORT AUTH(LOC; PNC Bank NA)	-		610,000	1.85%	610,000
AMERICAN MUN PWR-OHIO INC	-		460,000	2.03%	460,000
WOODMERE VLG OHIO	-		765,000	1.05%	765,000
Fairborn Gen. Oblig. BAN Series 2017 B	-		100,000	1.75%	100,000
Marysville Gen. Oblig. BAN Series 2017	-		100,000	1.75%	100,000
OHIO HIGHER EDUCATIONALCP	-		19,000,000	0.00%	19,000,000
Total held by all Money Market Funds	4,607,098,700	0.10%	2,243,734,900	1.79%	(2,363,363,800)

Note: Fed funds rate		
Nominal	0.50%	1.75%
After tax*	0.30%	1.05%

* Assumes a 40% income tax rate

Attachment 3

Letters to Senator Brown

Attachment referenced in answer
to Question 6 from Senator Brown

County Commissioners Association of Ohio

Serving Ohio Counties Since 1880

Suzanne K. Dulaney, Esq., Executive Director

209 East State Street • Columbus, Ohio 43215-4309
Phone: 614-221-5627 • Fax: 614-221-6986
Toll Free: 888-757-1904 • www.ccao.org

August 7, 2015

The Honorable Sherrod Brown
713 Hart Senate Office Building
Washington, DC 20510

Dear Senator Brown:

I respectfully seek your assistance to address the negative impact of recent changes made by the Securities and Exchange Commission (SEC) pertaining to the structure of money market funds. The rule changes made by the SEC in 2014 risk impairing the ability of Ohio's counties to obtain low-cost financing for critical infrastructure projects.

CCAO, both individually and as a member of the National Association of Counties (NACo), have been advocating that money market mutual funds are important investment tools used by our counties. These funds contain substantial amounts of the short-term debt that local governments use to finance public works like roads, bridges, water and sewage treatment facilities, and other infrastructure and vital public facilities that are crucial to economic development. Unfortunately, the SEC proceeded with rule changes that forced money market mutual funds to abandon their stable price per share and instead "float" the net asset values (NAV).

County governments in Ohio operate under legal constraints that limit them from investing in instruments without a stable value. Without such financing, local governments may be forced to limit projects, spend more on financing or increase taxes due to the necessity of shifting to bank products that have historically paid lower yields or are much less secure.

I understand that Senator Toomey recently introduced the Consumer Financial Choice and Capital Markets Protection Act of 2015 (the "Act") which has now been introduced as S.1802. Under the Act, an Institutional Fund would be required to operate as a Floating NAV Fund unless its board of directors elected to operate as a Stable Value Fund. Any open-end investment fund, including an Institutional Fund, could operate as a money market fund that computes its price per share under the stable NAV approach. This legislation appears to be a reasoned approach to addressing the concerns of counties.

Please consider supporting S. 1802. I look forward to any assistance you can provide in supporting Ohio's counties. Please do not hesitate to contact me at (614)220-7977 with any questions or concerns.

Sincerely,

Suzanne Dulaney

Suzanne K. Dulaney
CCAO Executive Director

CORSA County Risk Sharing Authority
Fax: 614-220-0209
www.corsa.org

County Employee Benefits Consortium of Ohio CEBCO Counties Uniting for Affordable Health Benefits
Fax: 614-229-4588
www.cebco.org

CCAO County Commissioners Association of Ohio Service Corporation
Fax: 614-221-6986
www.ccao.org

CTA

COUNTY TREASURERS ASSOCIATION OF OHIO

February 9, 2018

The Honorable Sherrod Brown
United States Senate
713 Hart Senate Office Building
Washington, DC 20510

Re: Urging support for S 1117, the Consumer Financial Choice and Capital Markets Preservation Act

Dear Senator Brown:

On behalf of Ohio's 88 county treasurers, we respectfully urge your support for Senate Bill 1117, which is currently pending in the Senate Banking, Housing, and Urban Affairs Committee. As the Chief Investment Officers for Ohio's 88 counties, our members are statutorily empowered to preserve, and whenever possible, leverage the counties' financial resources to fund needed public works projects to include enhanced infrastructure necessary for needed economic development. County governments use tax-exempt debt to finance various capital and public works projects. Money Market Funds ("MMFs") are significant purchasers of county tax-exempt obligations.

In October 2016 a Securities and Exchange Commission (SEC) rule requires MMFs to account for their underlying net asset value on a floating basis rather from a fixed sum. This rule change has caused prime MMFs to stop purchasing our debt. Accordingly, local governments have lost our largest purchaser of local government debt.

A second costly impact on our counties is the loss of enhanced financial returns on surplus government deposits. Most county treasurers use MMFs to help manage their short term cash flow needs. Senate Bill 1117 will enable MMFs to continue serving our members and provide elevated returns on statutorily approved investments.

You may hear from some of our individual member county treasurers during the course of the debate and we would urge you to reach out to any one of our members who would be more than happy to enlighten you upon the positive impact Senate Bill 1117 will have on our local communities.

Very truly yours,

Ellery S. Elick

Ellery Elick, Pickaway County Treasurer
President of the County Treasurers Association of Ohio

17 S. High St. Suite 750, Columbus, Ohio 43215
www.ohiocountytreasurers.org

COUNTY TREASURERS
ASSOCIATION OF OHIO

February 9, 2018

The Honorable Congresswoman Marcy Kaptur
United States House of Representatives
2186 Rayburn House Office Building
Washington, DC 20515

Re: Urging support for HR 2319, the Consumer Financial Choice and Capital Markets Preservation Act

Dear Congresswoman Kaptur:

On behalf of Ohio's 88 county treasurers, we respectfully urge your support for HR 2319, which is currently pending in the House Financial Services Committee. As the Chief Investment Officers for Ohio's 88 counties, our members are statutorily empowered to preserve, and whenever possible, leverage the counties' financial resources to fund needed public works projects to include enhanced infrastructure necessary for needed economic development. County governments use tax-exempt debt to finance various capital and public works projects. Money Market Funds ("MMFs") are significant purchasers of county tax-exempt obligations.

In October 2016 a Securities and Exchange Commission (SEC) rule requires MMFs to account for their underlying net asset value on a floating basis rather from a fixed sum. This rule change has caused prime MMFs to stop purchasing our debt. Accordingly, local governments have lost our largest purchaser of local government debt.

A second costly impact on our counties is the loss of enhanced financial returns on surplus government deposits. Most county treasurers use MMFs to help manage their short term cash flow needs. HR 2319 will enable MMFs to continue serving our members and provide elevated returns on statutorily approved investments.

You may hear from some of our individual member county treasurers during the course of the debate and we would urge you to reach out to any one of our members who would be more than happy to enlighten you upon the positive impact HR 2319 will have on our local communities.

Very truly yours,

Ellery S. Elick

Ellery Elick, Pickaway County Treasurer
President of the County Treasurers Association of Ohio

17 S. High St. Suite 750, Columbus, Ohio 43215
www.ohiocountytreasurers.org

OHIO COUNCIL OF COUNTY OFFICIALS

President	Vice-President	Secretary/Treasurer
Jerry R. McBride Clermont Co. CPC Judge	Scott C. Coleman Logan County Engineer	Jill Thompson Athens County Auditor

August 9, 2017

The Honorable Sherrod Brown
United States Senate
713 Hart SOB
Washington, D.C. 20510

Re: Support S.1117, the Consumer Financial Choice and Capital Markets Protection Act of 2017

On behalf of the Ohio Council of County Officials ("OCCO"), we respectfully urge your support for S.1117, legislation that would remedy an unintended consequence of money market reform. OCCO is a statewide organization that includes three representatives from each of the following county elected officials' associations:

- County Auditors Association of Ohio
- County Clerk of Courts Association
- County Commissioners Association of Ohio
- Ohio State Coroners Association
- County Engineers Association of Ohio
- Ohio Judicial Conference
- Ohio Prosecuting Attorneys Association
- Ohio Recorders Association
- Buckeye State Sheriffs Association
- County Treasurers Association of Ohio

S. 1117 would reduce the adverse consequences of a recently implemented Securities and Exchange Commission (SEC) rule, which required money market funds to switch from a fixed net asset value to a floating net asset value. This SEC rule had the negative effect of eliminating $1.2 trillion of capital markets financing for state and local infrastructure projects.

Counties rely on access to money market funds to finance the construction and maintenance of water supply systems, roads, public transportation systems, and other important infrastructure projects. They also rely on money market funds to invest short-term cash because of their secure nature, simple accounting methodology, and liquidity. These are features that are necessary to protect public funds, access cash and pay bills when they are due.

S. 1117 will help remedy the problems created by the SEC rule by allowing money market funds to operate on a stable net asset value basis as permitted over the past forty plus years. It also addresses an artificial barrier to the utilization of money market funds by municipalities due to internal investment policies that require immediate liquidity and the preservation of principal.

To keep Ohio's economy growing, I strongly urge your support for S.1117, and ask that you advocate for its adoption. Thank you for your consideration of this request and we have enclosed our letter from last Congress urging your support of similar legislation. S. 1802.

Sincerely,

Scott C. Coleman, P.E., P.S.
OCCO Vice-President

OHIO COUNCIL OF COUNTY OFFICIALS

President	Vice-President	Secretary/Treasurer
Jerry R. McBride Clermont Co. CPC Judge	Scott C. Coleman Logan County Engineer	Jill Thompson Athens County Auditor

August 9, 2017

The Honorable Rob Portman
United States Senate
448 Russell SOB
Washington, D.C. 20510

Re: Support S.1117, the Consumer Financial Choice and Capital Markets Protection Act of 2017

On behalf of the Ohio Council of County Officials ("OCCO"), we respectfully urge your support for S.1117, legislation that would remedy an unintended consequence of money market reform. OCCO is a statewide organization that includes three representatives from each of the following county elected officials' associations:

- County Auditors Association of Ohio
- County Clerk of Courts Association
- County Commissioners Association of Ohio
- Ohio State Coroners Association
- County Engineers Association of Ohio
- Ohio Judicial Conference
- Ohio Prosecuting Attorneys Association
- Ohio Recorders Association
- Buckeye State Sheriffs Association
- County Treasurers Association of Ohio

S. 1117 would reduce the adverse consequences of a recently implemented Securities and Exchange Commission (SEC) rule, which required money market funds to switch from a fixed net asset value to a floating net asset value. This SEC rule had the negative effect of eliminating $1.2 trillion of capital markets financing for state and local infrastructure projects.

Counties rely on access to money market funds to finance the construction and maintenance of water supply systems, roads, public transportation systems, and other important infrastructure projects. They also rely on money market funds to invest short-term cash because of their secure nature, simple accounting methodology, and liquidity. These are features that are necessary to protect public funds, access cash and pay bills when they are due.

S. 1117 will help remedy the problems created by the SEC rule by allowing money market funds to operate on a stable net asset value basis as permitted over the past forty plus years. It also addresses an artificial barrier to the utilization of money market funds by municipalities due to internal investment policies that require immediate liquidity and the preservation of principal.

To keep Ohio's economy growing, I strongly urge your support for S.1117, and ask that you advocate for its adoption. Thank you for your consideration of this request and we have enclosed our letter from last Congress urging your support of similar legislation. S. 1802.

Sincerely,

Scott C. Coleman, P.E., P.S.
OCCO Vice-President

Ohio Municipal League
Our Cities and Villages ★ Bringing Ohio to Life

August 20, 2015

The Honorable Sherrod Brown
United States Senate
713 Hart Senate Office Building.
Washington DC 20510

Re: The Consumer Financial Choice and Capital Markets Presentation Act of 2015 (SB 1802)

Dear Senator Brown:

On behalf of the 900 + villages and cities in Ohio, we respectfully urge you to support Senate Bill 1802, which is currently pending before the Senate Banking, Housing, and Urban Affairs Committee. This legislation will enable our members to cost efficiently fund desperately needed public works projects to include an enhanced infrastructure necessary for needed economic development. This is an especially important tool for local government since the state has deceased the funding to local governments. Local governments use short-term debt to finance various capital and public works projects. Money Market Funds are significant purchasers of municipal obligations. Without Senate Bill 1802, Money Market Funds may no longer purchase such debt after October 2016 when the fund's underlying net asset value moves from a fixed sum to a floating value.

We are very concerned that local governments will lose the largest purchaser of local government debt if money market funds are not permitted to retain a fixed net asset value. A second costly impact is the loss of enhanced financial returns on surplus government deposits. Most of our members use the Star Ohio program to help manage their cash flow needs. Senate Bill 1802 will enable this program to continue serving our members and provide elevated returns on statutorily approved investments.

We thank you in advance for your consideration. You may hear from some of our individual members during the course of the debate and we would urge you to reach out to any one of our member's cities who would be more than happy to enlighten you upon the positive impact of Senate Bill 1802.

Very truly yours,

Susan J. Cave
Executive Director

NAN WHALEY
MAYOR

OFFICE OF THE MAYOR
CITY HALL • 101 WEST THIRD STREET
P.O. BOX 22 • DAYTON, OHIO 45401
(937) 333-3636 • www.daytonohio.gov

March 1, 2016

The Honorable Sherrod Brown
United States Senate
713 Hart Senate Office Building
Washington, DC 20510

Dear Senator Brown:

On behalf of the City of Dayton, I urge your support Senate Bill 1802, a bipartisan bill which will ensure that Dayton can continue to cost-efficiently fund much needed public works projects.

Dayton is home to renowned universities, premier medical centers, entrepreneurs and inventors and boasts world-class research and development in the fields of aviation as well as industrial and aeronautical engineering. Like many older Midwestern cities, we need to expand upon existing infrastructure to remain competitive.

Senate Bill 1802 is a narrow fix in response to a rule by the Securities and Exchange Commission ("SEC") pertaining to money market funds ("MMFs"). The SEC rule, effective October 2016, will require MMFs to switch from a fixed amortized valuation or a stable net asset value ("NAV") of $1 per share price, to a floating NAV. According to Crain's, this switch has caused over fifty (50) MMFs to either liquidate all of their assets or switch to U.S. obligations. MMFs have been significant purchasers of tax-exempt obligations and we fear that without Senate Bill 1802, which would allow the NAV to remain fixed, MMFs may no longer purchase our debt. If MMFs no longer purchase our tax-exempt bonds, the cost to build capital and public works projects in and around Dayton will increase.

As such, passage of Senate Bill 1802 is critical in allowing us to continue to cost-effectively fund facility improvements and expanded services to include enhanced infrastructure necessary for needed economic development. In addition, these projects create or sustain hundreds of prevailing wage jobs for the local construction trades, which in turn, support our local economies.

Furthermore, Dayton relies on MMFs for short and mid-term investing needs, as well as to protect principal, ensure liquidity and maximize returns on our surplus cash. We invest in MMFs because of their simple accounting methodology and management, security and liquidity. These are all features that are necessary for Dayton to protect public funds, access cash, and pay our bills when they become due.

Please join the City of Dayton, the Ohio Municipal League, the Ohio Council of County Elected Officials, labor leaders, universities, hospitals and others across the state, in supporting Senate Bill 1802. Unfortunately, the impact of this particular rule change could have a dampening effect upon our ability to attract and retain a vibrant economy leveraged with new infrastructure. Please feel free to contact me should you have any questions.

Sincerely,

Nan Whaley

Nan Whaley
Mayor

THE UNIVERSITY OF TOLEDO • OFFICE OF THE PRESIDENT

June 14, 2017

The Honorable Sherrod Brown
United States Senate
713 Hart SOB
Washington, D.C. 20510

Re: Support S.1117, the Consumer Financial Choice and Capital Markets Protection Act of 2017

Dear Senator Brown:

Enclosed please find our letter from last Congress urging your support of legislation that would remedy an unintended consequence of money market reform. A Securities and Exchange Commission (SEC) rule, which required money market funds to switch from a fixed net asset value to a floating net asset value, had the negative effect of eliminating $1.2 trillion of capital markets financing for state and local infrastructure projects. As long as the money stays parked in the federal government funds, it is not available to fund facility and capital improvements for: local schools, hospitals, universities, sewer and clean water facilities, roads and bridges, airports, public transit, affordable public housing, and other job creating infrastructure projects, all of which finance these projects through prime and tax-exempt municipal money market funds. Because there has been a large reduction in money market funds as a direct result of the rule, we have experienced a substantial increase in the cost of financing our capital projects.

As an issuer and investor in prime and tax-exempt funds, we continue to be negatively impacted by higher borrowing costs through increased short-term borrowing interest rates and limited returns on surplus cash because of this rule. Moreover, many public entities are limited and/or prohibited from investing in instruments that do not have a stable value.

To keep Ohio's economy growing, we strongly urge you to support the re-introduced legislation, S.1117, and advocate for its adoption. Please feel free to contact me should you have any questions.

Sincerely,

Sharon L. Gaber, Ph.D.
President

2801 W. Bancroft St., Toledo, Ohio 43606-3390 • 419.530.2211 • Fax 419.530.4984
sharon.gaber@utoledo.edu • www.utoledo.edu

MetroHealth

November 18, 2015

The Honorable Sherrod Brown
United States Senate
713 Hart Senate Office Building
Washington, DC 20510

Dear Senator Brown:

The MetroHealth System is a nationally ranked public health care system located in Cleveland, Ohio. Founded in 1837 as City Hospital, MetroHealth has evolved into an integrated delivery system. The system continues to serve as a major employer and the essential ("safety net") health provider for tens of thousands of patients by providing state of the art facilities and advanced comprehensive diagnostic tools to ensure the greatest possible health outcomes for patients. We respectfully urge you to support Senate Bill 1802 to facilitate our ability to invest in options that best protect the short and long term financial health of MetroHealth system. S-1802 is currently pending in the Senate Banking, Housing, and Urban Affairs Committee.

As you may know, MetroHealth and other hospitals use municipal / tax-exempt debt to finance various capital and public works projects. These projects create or sustain hundreds of prevailing wage jobs for the local construction trades. Your constituents benefit from state of the art facilities financed primarily with tax-exempt bonds. Passage of Senate Bill 1802 would enable MetroHealth to continue cost-efficient funding of facility improvements and to expand services to include enhanced infrastructure necessary for patient care and economic development purposes.

Today, Money Market Funds (MMFs) are significant purchasers of tax-exempt obligations. MetroHealth, along with many other issuers of tax-exempt bonds, fear that without the passage of Senate Bill 1802, MMFs may no longer purchase such debt after October 2016 when the fund's underlying net asset value moves from a fixed sum to a floating value. Without Money Market Funds to purchase our bonds, the cost of projects will be incrementally more expensive and could possibly limit our future growth.

With reduced reimbursement payments from insurance companies, Medicaid and Medicare, hospitals utilize short-term debt to finance various capital and public works projects. We need access to the lowest possible interest costs for tax-exempt financing to fund hospital facility improvements. In addition, our hospitals rely upon MMFs to support short and mid-term investing needs, to protect principal, ensure liquidity and maximize returns on surplus cash. Many Ohio healthcare facilities invest in MMFs because of their simple accounting methodology and management, security and liquidity. These are all features that are necessary for hospitals to protect their reserve funds, access cash, and to pay bills. Moreover, because hospitals are highly regulated and receive substantial reimbursements from CMS, we are subject to federal and state policies and legal restrictions requiring us to invest in funds that are stable and risk adverse. If the SEC's new floating NAV requirement is imposed on prime MMFs beginning in October of 2016, we may be forced out of these funds and directed to other investment vehicles that have historically paid lower yields.

We are deeply concerned that hospitals will lose a significant cash management tool if Money Market Funds are not permitted to retain a fixed net asset value. Therefore, we urge your support of Senate Bill 1802. We thank you in advance for your consideration. Please feel free to contact me or Tracy Carter, MetroHealth's senior director for federal and state affairs, at 216-778-1406, should you have any questions or comments.

Warm regards,

Tamiyka Rose

Tamiyka Rose
Vice President, Government Relations

Plain Township Board of Trustees

ESTABLISHED 1810 • BOX 273 • NEW ALBANY, OHIO 43054 • (614) 855-7770 • Fax (614) 855-7761

September 30, 2015

The Honorable Sherrod Brown
United States Senate
713 Hart Senate Office Building
Washington, DC 20510

Re: Requesting Support for The Consumer Financial Choice and Capital Markets Protection Act of 2015 (S-1802)

Dear Senator Brown,

I am currently serving as the fiscal officer of Plain Township, Franklin County, Ohio, which is located northeast of Columbus. It is a suburbanized township. It is home to nearly 11,000 residents and is known for its quiet neighborhoods, excellent school systems and expanding business community. As the Fiscal Officer, I am responsible for determining how townships funds are spent and managed. I believe the new Securities and Exchanges Commission ("SEC") Rule changes impacting money market funds ("MMFs") could have a negative impact upon the viability of MMFs and in turn, negatively impact local governments in Ohio.

I respectfully request your consideration for the passage of Senate Bill 1802, which I understand will be heard by members of the Senate Banking, Housing and Urban Affairs Committee. The Act would appear to correct a significant impediment to the SEC's 2014 money market reform rule while leaving other reforms in place. As the fiscal officer for Plain Township, Franklin County, Ohio, I am particularly concerned with the change requiring MMFs to switch from a fixed net asset value to a floating net asset value. The proposed legislation adds a mechanism for MMF sponsors to create a MMF with a fixed NAV, if the sponsor so requests at the time the fund is created. I support this change for a number of reasons.

As investors, local governments rely on MMFs to protect principal, ensure liquidity and maximize returns on surplus cash. Local governments do not have a steady and predictable inflow of revenue (tax payments and payments from local governments are collected only at certain times of the year), disbursements - including payroll and general bill paying - is constant. Many governments invest in money market funds because of their simple accounting methodology and management, security and liquidity. These are all features that are necessary for governments to protect public funds, access cash, and pay bills when they are due.

Many local governments are subject to policies and legal restrictions permitting them to invest only in funds that are stable and risk adverse. If the SEC's new floating NAV requirement is imposed on prime MMFs beginning in 2016, governments may be forced out of these funds and would have to look to other investment vehicles that have historically paid lower yields, or to other less secure products with equal or less liquidity than MMFs. All of these potential scenarios would reduce investment returns for Ohio's local governments.

For all of these reasons, we hope that you can support S-1802, allowing MMFs to maintain a fixed NAV for prime MMFs. Thank you for your consideration of this request.

Sincerely,

Bud Zappitelli, Fiscal Officer
Plain Township, Franklin County, Ohio

Attachment 4

Matrix of state investment policies

Attachment referenced in answer
to Question 6 from Senator Brown

ILLINOIS	
FUNDS	INVESTMENT IN MUTUAL FUNDS AND CONDITIONS
GENERAL FUNDS	
Public Agency Funds	Yes. Any public agency may invest any public funds in money market mutual funds registered under the Investment Company Act of 1940, provided that the portfolio of any such mutual fund is limited to: (1) bonds, notes, certificates of indebtedness, treasury bills or other securities, which are guaranteed by the full faith and credit of the United States as to principal and interest; and (2) bonds, notes, debentures and other similar obligations of the United States and its agencies. (*See* 30 ILCS 235/2)
State Funds	Yes. The State Treasurer may, with the approval of the Governor, invest or reinvest any state money in the treasury that is not needed for current expenditure in money market mutual funds registered under the Investment Company Act, provided that the portfolio of the fund is limited to permissible investments as listed in this section. (*See* 15 ILCS 520/22.5)
County Funds	No. (*See* 55 ILCS 5/3-11006)
General Obligation Bonds Retirement and Interest Fund	No. (*See* 30 ILCS 330/19)
Municipal Bond Proceeds	No. (*See* 65 ILCS 5/8-4.1-10)
School Funds	No. (*See* 105 ILCS 5/8-7, 105 ILCS 5/8-8)
Township Funds	No. (*See* 105 ILCS 5/8-8)
EMPLOYMENT RELATED FUNDS	
Retirement System or Pension Funds	Yes. The board of trustees of a retirement system or pension fund may invest, *inter alia*, in investment companies which: (1) are registered under the Investment Company Act; (2) are diversified, open-end management investment companies; and (3) invest only in money market instruments. (*See* 40 ILCS 5/1-113)
State Employees Deferred Compensation	Yes. Funds retained by the State as deferred compensation may be invested in such investments as are deemed acceptable by the Illinois State Board of Investment, including, but not limited to, life insurance, or annuity contracts or mutual funds. All such investments shall have been reviewed and selected by the Board based on a competitive bidding process. (*See* 40 ILCS 5/24-105)
Local government or School District Deferred Compensation Plan	Yes. The agency or department designated by the unit of local government or school district to establish and administer a deferred compensation plan may invest the assets of the plan in investments deemed appropriate by the agency or department. (*See* 40 ILCS 5/24-107)

ILLINOIS	
FUNDS	INVESTMENT IN MUTUAL FUNDS AND CONDITIONS
OTHER SIGNIFICANT FUNDS	
Education Service Region Funds	Yes. Funds of the Educational Service Region may be invested by the Educational Service Region in the same manner as Public Agency Funds are invested, except as otherwise provided in this Code. (*See* above) (*See* 30 ILCS 235/2, *supra*, 105 ILCS 5/3-9.1)
• Bond Proceeds allocated to the: • Capital Development Fund • Transportation Bond, Series A Fund • Transportation Bond, Series B Fund • School Construction Fund • Anti-Pollution Fund • Coal Development Fund	Yes. Money in such funds that is not needed for current expenditures may be invested in money market mutual funds registered under the Investment Company Act, provided that the portfolio of the fund is limited to: (1) permissible state investments as listed in 15 ILCS 520/22.5; (2) bonds, notes, certificates of indebtedness, treasury bills or other securities, which are guaranteed by the full faith and credit of the United States as to principal interest, and bonds, notes debentures and other similar obligations of the United States and its agencies. (*See* 30 ILCS 330/19, 15 ILCS 520/22.5, 30 ILCS 235/2)
Funds of the Illinois Development Finance Authority	Yes. Funds of the Authority may be invested in equity securities of an investment company registered under the Investment Company Act, whose sole assets, other than cash and other temporary investments, are obligations listed as eligible investments for the Authority. Additional restrictions are enumerated in this Code provision. (*See* 20 ILCS 3505/14)
Local Community College District Public Funds	Yes. These funds may be invested in any mutual funds that invest primarily in corporate investment grade or global government short term bonds, provided that such mutual funds have assets of at least $100 million and are rated at the time of purchase as one of the 10 highest classifications established by a recognized rating service. The investment shall be subject to approval by the local Community College Board of Trustees. Each Community College Board of Trustees shall develop a policy regarding the percentage of the college's investment portfolio that can be invested in such funds. (*See* 30 ILCS 235/2)

Code renumbered effective 1/1/93.
Citations are to ILL. COMP. STAT. ANN. ch. x, para. x (Smith-Hurd 19xx).

ILLINOIS	
FUNDS	**INVESTMENT IN MUTUAL FUNDS AND CONDITIONS**
GENERAL FUNDS	
Public Agency Funds "Public Agency" is defined to include the State of Illinois, the various counties, townships, cities, towns, villages, school districts, educational service regions, special road districts, public water supply districts, fire protection districts, drainage districts, levee districts, sewer districts, housing authorities, the Illinois Bank Examiners' Education Foundation, the Chicago Park District, and all other political corporations or subdivisions of the State of Illinois. (*See* 30 ILCS 235/1.)	Yes. Any public agency may invest any public funds in money market mutual funds registered under the Investment Company Act of 1940, provided that the portfolio of any such mutual fund is limited to (1) bonds, notes, certificates of indebtedness, treasury bills or other securities, which are guaranteed by the full faith and credit of the United States as to principal and interest; (2) bonds, notes, debentures and other similar obligations of the United States and its agencies; and (3) agreements to repurchase such obligations. (*See* 30 ILCS 235/2.) Public Agency Funds may be invested in the following portfolios of Money Market Obligations Trust: (1) Treasury Obligations Fund; (2) Government Obligations Tax Managed Fund; and (3) Government Obligations Fund.
General Obligation Bonds Retirement and Interest Fund	No. (*See* 30 ILCS 330/19.)

ILLINOIS	
FUNDS	**INVESTMENT IN MUTUAL FUNDS AND CONDITIONS**
EMPLOYMENT RELATED FUNDS	
Retirement System or Pension Funds	Yes. The board of trustees of a retirement system or pension fund may invest, *inter alia*, in investment companies which: (1) are registered under the Investment Company Act; (2) are diversified, open-end management investment companies; and (3) invest only in money market instruments. (*See* 40 ILCS 5/1-113.) In addition, up to 10% of the assets of the retirement system or pension fund may be invested in any other type of investment, including any mutual fund, provided that such investment complies with the prudent man rule set forth in 40 ILCS 5/1-109, 40 ILCS 5/1-109.1, 40 ILCS 5/1-109.2, 40 ILCS 5/1-110 and 40 ILCS 5/1-111.
State Employees' Deferred Compensation	Yes. Funds retained by the State as deferred compensation may be invested in such investments as are deemed acceptable by the Illinois State Board of Investment, including, but not limited to, life insurance, or annuity contracts or mutual funds. All such investments shall have been reviewed and selected by the Board based on a competitive bidding process. (*See* 40 ILCS 5/24-105.)
Local government or School District Deferred Compensation Plan	Yes. The agency or department designated by the unit of local government or school district to establish and administer a deferred compensation plan may invest the assets of the plan in investments deemed appropriate by the agency or department (*See* 40 ILCS 5/24-107.)

ILLINOIS	
FUNDS	**INVESTMENT IN MUTUAL FUNDS AND CONDITIONS**
OTHER SIGNIFICANT FUNDS	
Educational Service Region Funds	Yes. Funds of the Educational Service Region may be invested by the Educational Service Region in the same manner as Public Agency Funds are invested. (*See* above) (*See* ILCS 235/2, *supra*, 105 ILCS 5/3-9.1.)
• Bond Proceeds allocated to the: • Capital Development Fund • Transportation Bond, Series A Fund • Transportation Bond, Series B Fund • School Construction Fund • Coal Development Fund	Yes. Money in such funds that is not needed for current expenditures may be invested in same manner as Public Agency Funds are invested. (*See* 30 ILCS 235/2, *supra*, 30 ILCS 330/19.)
Funds of the Illinois Development Finance Authority	Yes. Funds of the Authority may be invested by the Authority in the same manner as Public Agency Funds are invested. In addition, Funds of the Authority may be invested in equity securities of an investment company registered under the Investment Company Act, whose sole assets, other than cash and other temporary investments are obligations listed as eligible investments for the Authority. Additional restrictions are enumerated in this Code provision. (*See* 30 ILCS 235/2, *supra*, 20 ILCS 3505/14.)
Community College Funds	Yes. Community College Funds may be invested in the same manner as Public Agency Funds are invested. (*See* 30 ILCS 235/2, *supra*, 110 ILCS 805/3-47.)

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTERS AND STATEMENTS SUBMITTED BY CHAIRMAN CRAPO

VIEWPOINT

JUN 2018
UPDATE

BLACKROCK®

US Money Market Fund Reform: Assessing the Impact

"The MMF reforms were not fully implemented until October 2016, and I am concerned that making major changes at this time could be disruptive to the short-term funding markets."

— Hon. Jay Clayton, Chairman, Securities and Exchange Commission Oct. 5, 2017

In 2014, reforms for US money market funds (MMFs) were adopted to address problems that surfaced during the 2008 financial crisis (2008 Crisis).[1] The reforms resulted from years of debate that included consideration of many reform options. Among the final reforms was a requirement that institutional prime and municipal MMFs convert to floating net asset value (FNAV) funds from constant net asset value (CNAV). In general, this led to net outflows from institutional prime and municipal MMFs. Though, recently, we have observed renewed interest in both prime and municipal strategies, albeit at a measured pace, suggesting the decline in these strategies may not be permanent.

Some have called for a roll back of the MMF reforms due to concerns about rising borrowing costs for municipal issuers. In contrast, an October 2017 letter written by Securities and Exchange Commission (SEC) Chairman, Jay Clayton, stated: "I am concerned that making major changes at this time could be disruptive to the short-term funding markets."[2] In our view, conclusive data-driven analysis should precede policy action. To date, analyses of the impact of MMF reform on borrowing costs are, at best, inconclusive. Notably, MMF reforms were initiated during a period of historically low interest rates (and hence, historically low borrowing costs) that was followed by several interest rate increases by the Federal Reserve and US tax reform. It is, therefore, not surprising that borrowing costs for all issuers have increased along with the Federal Reserve rate hikes, irrespective of MMF reform.

Over a year and a half after implementation, the impact and effectiveness of MMF reform should be reviewed. As the primary regulator of MMFs, the SEC is best placed to perform this analysis. We do not believe a roll back of the rules is advisable without first studying the effects of MMF reforms and the implications of any potential changes.

In this *ViewPoint*...

- MMF reforms were adopted to address structural weaknesses that led to government support for money markets in 2008.
- Efforts to roll back reforms must carefully consider the reasons why these rules were implemented in the first place.
- Arguments that MMF reform is driving higher borrowing costs for municipalities fail to fully consider the rising interest rate environment in which MMF reform was implemented, as interest rates are a primary driver of borrowing costs.
- While there is evidence of a temporary market dislocation due to MMF reform, the data supporting longer-term impacts is inconclusive.
- The SEC should conduct a study of the effects of MMF reform before determining whether rule changes are necessary or appropriate.
- We do not believe a roll back of the rules is advisable without first studying the effects of MMF reforms and the implications of any potential changes.

The opinions expressed are as of June 2018 and may change as subsequent conditions vary.

GR0118G-374449-1305400

Key Observations and Recommendations

MMFs experienced challenges during the 2008 Crisis that led to calls for reform.

- The "breaking of the buck" by the Reserve Primary Fund resulted in historic outflows across the MMF industry.
- Government intervention helped calm investors and stabilize outflows.
- Subsequently, MMFs became a priority issue for post-Crisis reform.

The Securities and Exchange Commission (SEC) adopted reforms for US MMFs in 2010 to require more conservative portfolio construction, followed by structural reforms in 2014.

- Among the 2014 reforms was a requirement that institutional prime and municipal MMFs adopt a floating NAV.
- The final compliance date for the structural reforms was October 2016.

The extensive reforms to MMFs warrant review to fully understand the impacts on financial stability, short-term funding markets, issuers, and MMF investors.

- We recommend that the SEC conduct this study, as the SEC is the primary regulator of MMFs and their sponsors, as well as US capital markets.
- Based on this analysis, policy makers can determine if any additional modifications to rules for US MMFs are warranted.
- We do not believe a roll back of the rules is advisable without first studying the effects of MMF reforms and the implications of any potential changes.

Short-term funding markets are complex; borrowing costs reflect numerous factors.

- Monetary policy, issuer credit quality, tax reform, and supply and demand are just a few of the factors that need to be considered.
- Claims that MMF reform has caused rising borrowing costs for municipal issuers do not fully consider all relevant factors.
- Objective analyses of borrowing costs must control for the fact that MMF reform coincided with a rising interest rate environment.
- Following seven years of near zero short-term rates, the Federal Open Market Committee (FOMC) raised the Fed Funds target rate six times between December 2015 and May 2018. In addition, on June 14, 2018, the FOMC announced an additional rate hike.

MMF Reform: How Did We Get Here?

Although MMFs had existed for several decades prior to 2008, the 2008 Crisis exposed structural weaknesses in MMFs. Specifically, the "breaking of the buck" by the Reserve Primary Fund, a MMF that held substantial amounts of Lehman Brothers' commercial paper in September 2008, led to historic net outflows across the MMF industry, as illustrated in Exhibit 1. To stabilize MMFs, the Federal Reserve and the US Treasury Department initiated several programs to help stabilize the MMF market.[3] For example, on September 19, 2008, the US Treasury Department announced the Temporary Guarantee Program for Money Markets Funds, which temporarily protected MMF shareholders from losses.[4]

Given this unprecedented government intervention into money markets, it is not surprising that policy makers sought to implement reforms to avoid such a scenario in the future. While one can debate the necessity of some aspects of the US MMF reforms, the reality is that the SEC approved these rule changes after several years of debate and data-driven analyses. Importantly, fund sponsors were given time to implement changes, and market participants have largely adapted.

Exhibit 1: Assets in 2a-7 MMFs
2006-2018

Source: iMoneyNet. As of May 31, 2018.

Exhibit 2: Selected Elements of Current SEC Regulations for MMFs

Investor Type	MMF Type	NAV	Redemption Fee	Redemption Gate
Institutional	Prime	Floating	Up to 2%	Up to 10 business days
Institutional	Municipal / Tax Exempt	Floating	Up to 2%	Up to 10 business days
Institutional / Retail	Government	Stable	None*	None*
Retail	Prime	Stable	Up to 2%	Up to 10 business days
Retail	Municipal / Tax Exempt	Stable	Up to 2%	Up to 10 business days

Source: SEC. *Government MMFs are permitted but not required to impose redemption liquidity fees and restrictions.
Grey box highlights new requirements that had not been in place prior to the 2014 reforms.

As shown in Exhibit 2, among the structural reforms adopted in the 2014 reforms was a requirement for institutional prime and municipal MMFs to convert to FNAV, meaning they are no longer permitted to use amortized cost accounting to round the NAV to a stable $1.00 per share price. The reforms also require both retail and institutional prime and municipal MMFs to have the ability to implement a redemption liquidity fee and redemption gates during times of stress.

The final SEC reforms followed several years of vigorous debate about the way forward for MMFs, which included the consideration of many alternative solutions. Exhibit 3 provides a timeline of MMF reform discussions from the 2008 Crisis until July 2014 when the reforms were finalized by the SEC. During this period, many MMF investors were challenged by the lack of certainty around the future of MMFs. We believe materially altering Rule 2a-7 again would create uncertainty for investors and potentially disruptions to the short-term funding markets. As such, new reforms should only be undertaken if there is conclusive evidence that MMF reform has resulted in unintended consequences. This calls for careful study by the SEC before any policy actions are taken.

Exhibit 3: Major Reform Milestones

Date	Milestone
Sep '08	Reserve Primary Fund "broke the buck"
Feb '10	SEC adopted certain Rule 2a-7 amendments strengthening the liquidity of the portfolios; effective May 2010
Mar '11	SEC proposed rules to eliminate certain references to credit ratings in MMF forms
Sep '12	Treasury Secretary Geithner letter urging SEC and industry to re-take up issue of reform
Nov '12	FSOC* releases reform proposal for comment
Jun '13	SEC releases proposal including conversion to FNAV for prime institutional MMFs
Mar '14	SEC issues 4 economic studies regarding MMFs, solicits public comment
Jul '14	SEC finalizes MMF reforms; effective October 2016

Source: BlackRock.
*FSOC stands for Financial Stability Oversight Council.

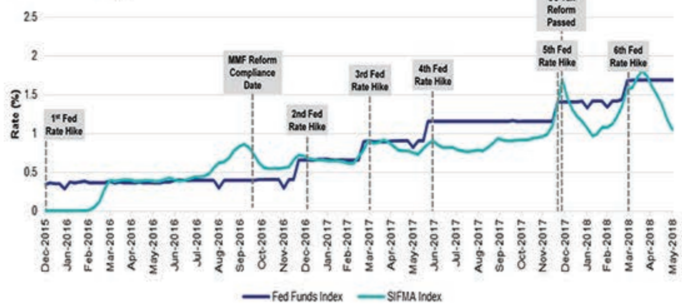
MMF Reform and Cost of Funding for Municipalities: Context and Timing are Important Factors

Recognizing that MMFs play an important role in the economy by providing a source of short-term funding to commercial and municipal borrowers, policy makers should study the potential implications of these reforms. That said, it is important that analyses do not consider isolated data points, but rather take a comprehensive approach that considers the broader context, as short-term funding markets are complex and borrowing costs reflect numerous factors.

For example, some critics of MMF reform have argued that borrowing costs for municipalities have increased sharply as a result of the MMF reforms. They cite a 91 basis point increase in the SIFMA Municipal Swap Index (SIFMA Index) between January 2016 and August 2017 as the basis for this conclusion.[5] The SIFMA Index represents the average yield on 7-day municipal Variable Rate Demand Notes (VRDNs).[6] This index is widely used as a benchmark to measure the average cost of borrowing for municipal issuers. When considered in isolation, this increase in funding costs might be cause for concern. However, when assessing borrowing costs for issuers, the interest rate environment is important to consider, given that monetary policy is a key driver of borrowing costs.

As shown in Exhibit 4, which plots the SIFMA Index and the Fed Funds rate, the FOMC increased the Fed Funds target rate six times between December 2015 and May 2018.[7] As such, the implementation of US MMF structural reforms directly coincided with a rising interest rate environment. In addition, during this window, the Fed announced the end of

Exhibit 4: Fed Funds and SIFMA Index
December 2015 – May 2018

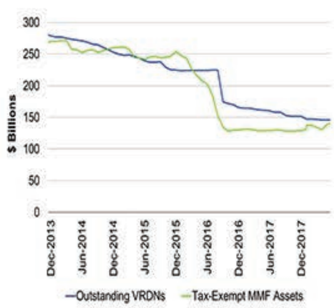


Source: Bloomberg, BlackRock. As of May 31, 2018.

Quantitative Easing (QE), and began reducing its balance sheet.[8] While the SIFMA Index and Fed Funds rate largely move in line with each other, there are periods of divergence. These include both periods where the SIFMA Index is below and above Fed Funds. For example, in late 2015 to early 2016, the SIFMA Index diverged from the Fed Funds rate when assets of Tax Exempt MMFs exceeded inventories of available VRDNs, creating a scenario in which high demand was driving prevailing rates in VRDNs lower. This dynamic is shown in Exhibit 5. Likewise, the SIFMA Index spiked just as MMF reforms approached the October 2016 compliance date. The SIFMA Index spiked again at the end of 2017 due to a dramatic increase in municipal issuance as a result of US tax reform. Exhibit 4 shows the SIFMA Index below and above the Fed Funds rate at different points in time. Given these fluctuations, any analysis will be sensitive to the start and end dates of the study, requiring careful consideration before drawing conclusions.

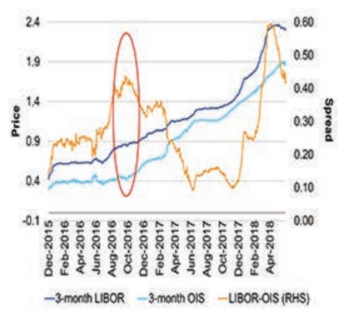
Looking more closely at the spike in October 2016, the months just before and just after MMF reform implementation represented a period of uncertainty. Since fund managers were unsure, at the time, as to the amount of assets that would flow out of prime and municipal MMFs, as the final compliance date for reforms approached, most institutional prime and municipal MMF managers increased the amounts of liquidity they were holding and shortened the maturity profiles of their portfolios. This dynamic appears to have contributed to a temporary rise in borrowing costs, as the demand for shorter-dated assets increased relative to supply. The dynamic was most noticeable in the spike in the LIBOR-OIS spread, as adjustments in commercial paper markets[9] were similar to municipal markets. As shown in Exhibit 6, this dislocation was temporary in nature and reversed relatively quickly thereafter.

Exhibit 5: Tax Exempt MMF Assets v. VRDNs Outstanding



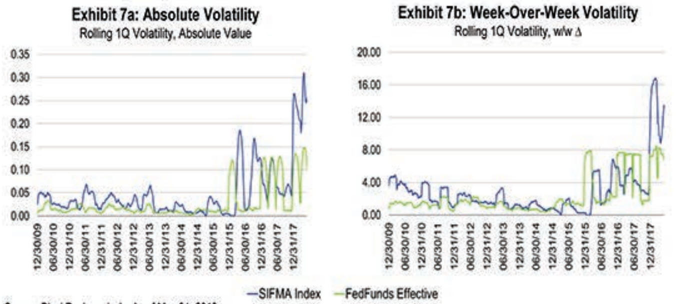
Source: Barclays. As of May 31, 2018.

Exhibit 6: LIBOR-OIS Spread



Source: Bloomberg. As of May 31, 2018.

Exhibit 7: Volatility Analysis



Source: BlackRock analysis. As of May 31, 2018.

In the months leading up to and shortly following October 2016 when the reforms were fully implemented, municipal MMF outflows contributed to a period of elevated dealer VRDN inventory, as municipal MMFs, which had been traditional purchasers of VRDNs, had less demand. This dynamic can be observed in Exhibit 5. As a result, VRDN yields were higher to attract crossover and short duration buyers, creating a temporary dislocation in the SIFMA Index.

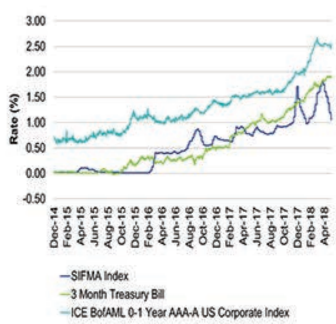
To further analyze the impact of interest rate dynamics on municipal borrowing costs, we performed a volatility analysis of the SIFMA Index and the Fed Funds rate. Exhibit 7a looks at the absolute volatility of each rate, and Exhibit 7b depicts the volatility of week over week changes in each rate.[10] While this analysis shows that there was volatility around MMF reform and US tax reform, we do not observe any volatility regime shift for the SIFMA Index relative to the Fed Funds rate. This further supports the conclusion that much of the increase in borrowing costs for municipalities is a product of the rising interest rate environment. We note that this analysis reflects a simple approach and there are several other factors that can impact municipal funding, including issuer credit quality, tax reforms, and supply and demand. These dynamics would need to be considered in order to develop a comprehensive assessment of the impact of MMF reform. We encourage the SEC to undertake this comprehensive analysis.

While commentators have pointed to an increase in borrowing costs for municipal issuers as a direct impact of MMF reform, the evidence to support this assertion is not conclusive when the interest rate environment is taken into account. As shown in Exhibit 4, between December 2015 and May 2018, the Fed Funds rate increased from 0.13% to 1.7%, a 157 basis point increase. During this same time period, the SIFMA Index increased from 0.01% to 1.06%, a 105 basis point increase. With this context in mind, borrowing costs for municipalities appear in line with what would be expected during this period of interest rate normalization.

One counterargument that has been noted is that interest rate dynamics do not fully explain the trend in increased borrowing costs for municipalities, as there is a yield differential between taxable and tax exempt bonds that is not fully depicted in this data.[11] We believe this differential exists given the supply-demand dynamics that occurred around money market reform and again around US tax reform, but that ultimately the market did and will normalize. Further, we believe the reduction in the corporate tax rate resulting from tax reform is causing the market to find a new equilibrium that differs from historical periods.

Importantly, aside from the temporary dislocation around the time of the MMF reform compliance date, borrowing costs in municipal markets have followed a similar trend as other short-term taxable fixed income markets. This is illustrated in Exhibit 8, which compares the SIFMA Index to the 3-month Treasury bill, and the ICE BofAML 0-1 Year AAA-A US Corporate Index, which is a measure of short-term funding rates for highly rated corporates.

Exhibit 8: Short-Term Interest Rates – Multiple Markets



Source: Bloomberg. As of May 31, 2018.

Conclusion

In sum, while it is no question that there has been an increase in borrowing costs for issuers (correlation), when we control for the rising interest rate environment and the effects of tax reform, the evidence to support a causal relationship between MMF reform and a *permanent* increase in municipal borrowing costs is inconclusive. Temporary market impacts have been observed over the course of implementation of MMF reforms, but this does not appear to have had a permanent impact beyond the natural increase in borrowing costs associated with interest rate normalization. Clearly, more comprehensive analysis will need to be performed before any conclusions can be drawn.

As was suggested at the time of MMF reform, MMF reforms should be monitored for their effectiveness in mitigating financial stability risks.[12] Now that full implementation has taken place, a review of the impacts on financial stability, short-term funding markets, issuers, and MMF investors is warranted. In light of the 2008 Crisis and the experience of MMFs, this review needs to consider the effectiveness of MMF reforms as well as identify any unintended consequences. As the regulator for MMFs and their sponsors, the SEC is best positioned to conduct this review. We do not believe a roll back of the rules is advisable without first studying the effects of MMF reforms and the implications of any potential changes.

Endnotes

1. See Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47735 (Aug. 14, 2014); Money Market Fund Reform, 75 Fed. Reg. 10060 (Mar. 4, 2010) (Release No. IC-29132; File Nos. S7-11-09, S7-20-09).
2. SEC Chairman Jay Clayton, Letter to Hon. Carolyn Maloney, Ranking Member, Subcommittee on Capital Markets, Securities and Investment, Committee on Financial Services (Oct. 5, 2017).
3. Details of the Fed's crisis era liquidity support programs can be found here: https://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm.
4. US Treasury Dept., Treasury Announces Temporary Guarantee Program for Money Market Funds (Sep. 6, 2008), available at https://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx.
5. Treasury Strategies, Inc. "Public Sector Funding Costs: A Rebuttal."
6. Variable Rate Demand Notes (VRDNs) are floating rate municipal instruments that carry a 1 or 7 day put option. VRDN's typically represent approximately 80% of the securities in municipal money market funds (source: iMoneyNet)
7. The FOMC announced a seventh rate hike (since Dec. 2015) on Jun. 14, 2018. Federal Reserve, FOMC's target federal funds rate or range, change (basis points) and level as of June 14, 2018, available at https://www.federalreserve.gov/monetarypolicy/openmarket.htm.
8. Federal Reserve, Press Release, Federal Reserve issues FOMC statement (Sep. 20, 2017), available at https://www.federalreserve.gov/newsevents/pressreleases/monetary20170920a.htm.
9. Commercial paper is often used by Prime MMFs as an important investment. Prime MMFs saw a decrease in assets of $1 trillion as a result of MMF reform, as many MMF investors moved into Government MMFs. The LIBOR-OIS spread measures the difference between two important interest rates, the London Interbank Offered Rate (LIBOR) and the Overnight Indexed Swap (OIS) rate. This is often used as a key measure of credit risk in the banking sector.
10. 2017 year end volatility in SIFMA Index resulted from increased municipal issuance in advance of tax reform.
11. Treasury Strategies, Inc. "Public Sector Funding Costs: A Rebuttal."
12. Statement from Secretary Lew on the Final Money Market Mutual Fund Rule by the SEC (Jul. 23, 2014), available at https://www.treasury.gov/press-center/press-releases/Pages/jl2583.aspx.

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CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

NEIL L. BRADLEY
EXECUTIVE VICE PRESIDENT &
CHIEF POLICY OFFICER

1615 H STREET, NW
WASHINGTON, DC 20062
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June 25, 2018

The Honorable Michael Crapo
Chair
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Brown:

The U.S. Chamber of Commerce supports a number of bills that the Committee is scheduled to consider at the June 26th hearing entitled "Legislative Proposals to Increase Access to Capital." The Chamber supports the following bills that would expand capital market access to America's small and mid-size businesses:

S. 588, the "Helping Angels Lead our Startups Act," would clarify that startups and angel investors are permitted to participate in "demo days" or other events in which no specific investment solicitation is made. This change is consistent with the original intent of the Jumpstart our Business Startups ("JOBS") Act of 2012 and would help innovative companies expand and hire new employees.

S. 2347, the "Encouraging Public Offerings Act of 2018," would allow any company – regardless of size or EGC status – to take advantage of Title I of the 2012 JOBS Act, such as allowing investors to submit confidential draft registration statements with the SEC and to "test the waters" before filing an IPO. Title I of the JOBS Act has proven to be a true policy success, and Congress and the SEC should continue to explore how more companies can take advantage of its provisions.

S. 2765, the "RBIC Advisers Relief Act of 2018," would help expand the flow of capital into rural communities by cutting down unnecessary red tape and regulatory requirements that are more appropriate for larger funds. Given the fact that post-recession business creation has largely been concentrated in large urban areas, this legislation would help create more opportunities in communities where business creation has been slow.

S. 3004, the "Small Business Audit Correction Act of 2018," would exempt privately-held non-custodial brokerage firms from a requirement to have a Public Company Accounting Oversight Board (PCAOB)-registered firm conduct their annual audit. Small broker-dealers are often important sources of capital for startups or small businesses around the country, and there is no compelling reason to subject them to an audit process that is more fitting of a large company.

The Chamber appreciates your work to have these bills considered and looks forward to working with the Committee as they advance through the legislative process.

Sincerely,

Neil L. Bradley

cc: Members of the Committee on Banking, Housing and Urban Affairs

INVESTMENT COMPANY INSTITUTE®

Paul Schott Stevens, PRESIDENT

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January 12, 2018

The Honorable Jeb Hensarling
Chairman, Committee on Financial Services
US House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member, Committee on Financial Services
US House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Hensarling and Ranking Member Waters:

I am writing on behalf of the Investment Company Institute[1] (ICI) to convey our opposition to H.R. 2319, the Consumer Financial Choice and Capital Markets Protection Act of 2017, a bill that would undo some of the Securities and Exchange Commission's (SEC) 2014 money market fund reforms, including the requirement that prime institutional and tax-exempt institutional money market funds float their net asset values (NAVs).

Since the early 1970s, money market funds have been a steady, predictable mainstay of finance. Today, more than 54 million retail investors, as well as corporations, municipalities, and other institutional investors, entrust some $2.8 trillion to money market funds as low-cost, efficient cash management tools that provide a high degree of liquidity, stability of principal value, and a market-based yield. Money market funds also serve as an important source of direct financing for state and local governments, businesses, and financial institutions, and of indirect financing for households. Without these funds, financing for all of these institutions and individuals would be more expensive and less efficient.

Money market funds owe their success, in large part, to the stringent regulatory requirements to which they are subject under the federal securities laws—including, most notably, Rule 2a-7 under the Investment Company Act. The regulatory regime under Rule 2a-7 has proven to be effective in protecting investors' interests and in sustaining their confidence in money market funds as a valuable tool for managing cash. The SEC has modernized and strengthened the rule from time to time as circumstances have warranted (most recently in 2010 and 2014, as discussed below).

[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$21.5 trillion in the United States, serving more than 100 million US shareholders, and US$7.1 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

In light of money market funds' experience in the financial crisis, and with the industry's strong support, the SEC in 2010 approved far-reaching rule amendments that enhanced an already-strict regime of money market fund regulation.[2] The amended rules made money market funds more resilient by, among other things, imposing new credit quality, maturity, and liquidity standards and increasing the transparency of these funds.

The SEC amended Rule 2a-7 again in 2014. The 2014 SEC rules, which took effect on October 14, 2016, focused on two principal reforms.[3] The first reform requires prime institutional and tax-exempt institutional money market funds to price and transact in their shares using "floating" net asset values. The new rules also require these funds to calculate their NAVs to four decimal places. (For a fund with a NAV of $1.00, that means calculating the NAV to one-hundredth of a penny—*i.e.*, $1.0000.) Government money market funds[4] and retail money market funds[5] may continue to seek to maintain a stable NAV using amortized cost valuation and/or penny rounding.

The second principal reform enables, and in certain cases requires, all non-government money market funds (*i.e.*, all prime and tax-exempt funds, whether institutional or retail) to impose barriers on redemptions (so-called liquidity fees and gates) during extraordinary circumstances, subject to determinations by a money market fund's board of directors. Specifically, the new rules give a money market fund's board the flexibility to impose liquidity fees of up to 2 percent, redemption gates (a delay in processing redemptions for up to 10 business days), or both if the fund's weekly liquid assets have dropped below 30 percent of its total assets. If a fund's weekly liquid assets fall below 10 percent of its total assets, the SEC rules require the fund to charge redeeming investors a fee of 1 percent of their redemption, unless the fund's board determines either that no fee, or a lower or higher fee (not to exceed 2 percent), would be in the best interests of the fund. When coupled with the 2010 SEC reforms, these new rules add layers of transparency and redundant safeguards that more than adequately address any risks that may have existed in 2008.

H.R. 2319 would rescind certain 2014 reforms, including the requirement that prime institutional and tax-exempt institutional money market funds float their NAVs. Although ICI and its members did not support many of the measures adopted in 2014, we were pleased that the reforms ultimately preserved money market

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[2] Money market funds in fact were the first part of the US financial system to be reformed in the wake of the financial crisis. *See Money Market Fund Reform*, SEC Release No. IC-29132 (February 23, 2010), 75 Fed. Reg. 10060 (March 4, 2010). Taking the initiative to respond quickly and aggressively to the events of fall 2008, ICI formed the Money Market Working Group to study the money market, money market funds, and other participants in the money market, and the financial crisis of 2007-2008. The March 2009 *Report of the Money Market Working Group* addressed these topics and advanced wide-ranging recommendations for the SEC to strengthen money market fund regulation. *See* Investment Company Institute, *Report of the Money Market Working Group* (March 17, 2009), available at https://www.ici.org/pdf/ppr_09_mmwg.pdf. The SEC's 2010 amendments incorporated many of the report's recommendations.

[3] *See Money Market Fund Reform; Amendments to Form PF*, SEC Release No. IC-31166 (July 23, 2014), 79 Fed. Reg. 47736 (August 14, 2014).

[4] Government money market funds invest at least 99.5 percent of their total assets in cash, government securities, and/or repurchase agreements that are collateralized by cash or government securities.

[5] Retail money market funds have policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons.

funds as a key cash management product for fund investors and a source of financing for businesses and governments. The new regulatory regime involved substantial and costly operational changes implemented on a very aggressive timetable, but money market funds and the money markets have adjusted to the reforms. The consensus of our member leadership is that reopening these reforms is not appropriate or desirable.

Thank you for your consideration of our views.

With very best regards.

Sincerely,

Paul Schott Stevens
President and CEO
Investment Company Institute

cc: Members of the Committee on Financial Services

THE WALL STREET JOURNAL.
WSJ.com

OPINION – November 22, 2012, 5:27 p.m. ET

Time for Compromise on Money-Market Reform

Not all money-market funds are created equal. The riskier 'prime' ones should be subject to a variable net-asset value.

By WALT BETTINGER

It is time to address the challenges that the country faces in a spirit of collaboration and compromise. As a firm serving the needs of millions of individual investors, Charles Schwab believes this includes compromise on money-market fund reform. A thoughtful and responsible compromise will help restore trust and confidence in our financial markets—and set an example for other urgent changes that are needed in Washington, D.C.

Money-market funds are a critically important tool for investors to manage their cash. Our firm has vigorously opposed "reform" proposals that would, in effect, put an end to them.

Still, there are reasonable arguments in favor of change. After more than two years of debating the merits of various regulatory proposals, Charles Schwab believes that requiring certain money-market funds to have a variable net-asset value is the right thing to do to bring the debate to closure—and to provide clarity for millions of investors who depend on these financial products.

A money-market fund faces two different kinds of risk. The first is "breaking the buck"—when the net-asset value of its investments falls below $1. The second kind of risk is a run—when investors race for the exit by redeeming their shares. Significantly, these two problems are characteristics of prime money-market funds and, more specifically, prime money markets in which institutions invest.

As far as risk goes, not all money-market funds are alike. A prime money-market fund invests in short-term, fixed-income securities issued by entities other than U.S.-based governments, such as corporations, banks, foreign governments and the like. The problem here is fairly obvious: If a company gets into trouble, a money-market fund's assets can decline and the value of its holdings may no longer equal $1 per share.

But nonprime money-market funds invest exclusively in securities issued by U.S.-based governments—Treasury bills, U.S. government agency debt and sometimes debt issued by state governments. These entities present far less risk.

Now consider the risk of a run. A run occurs when many investors all want out of a fund at the same time, right? Wrong. A run occurs when many investors who also represent a large percentage of the fund's total assets all want out of the fund at the same time.

Here's a simple example: If a retail money-market fund has one million shareholders and every shareholder owns one dollar in the fund, 50,000 investors can ask to liquidate on a single day and it won't create a run. However, if another fund, an institutional money-market fund, has 50,000 shareholders and 10,000 of them own 90% of the assets, you have a potential problem. If those 10,000 shareholders all want out on the same day, that's a run.

In the 2008 financial crisis, there was no evidence—none—that retail investors ran from their money-market funds. Institutional investors did run from their money-market funds—thus adding to the financial crisis.

But what about the Reserve Primary Fund, which broke the buck on Sept. 16, 2008, and experienced a run. Didn't it have retail investors? Yes, it did. But the Reserve Primary Fund mixed institutions and retail investors all in one fund. This meant that a run led by institutions left many retail investors holding the bag.

Mary Schapiro, chairman of the Securities and Exchange Commission, explained the problem neatly a few months ago in testimony before Congress. "Early redeemers tend to be institutional investors with substantial amounts at stake who can commit resources to watch their investments carefully and who have access to technology to redeem quickly," she said. "This can provide an advantage over retail investors who are not able to monitor the fund's portfolio as closely. As a consequence, a run on a fund will result in a wealth transfer from retail investors (including small businesses) to institutional investors."

When you lay out these facts, the solutions are pretty simple.

Most objective observers would say that money-market funds investing exclusively in U.S. Treasury instruments, U.S. government agency paper or debt issued by states have minimal credit risk. These "nonprime" money-market funds should continue to operate as they do now with careful oversight, transparency, regulation by the SEC and a stable $1 per share net-asset value.

But prime money-market funds do have a degree of potential credit risk that could arise in extreme capital-market credit crises. And the reaction of institutional investors in these funds to this credit risk creates a potential for runs.

Retail and institutional prime funds should be treated in ways that reflect their risk.

Institutional prime money-market funds—meaning any fund in which a shareholder owns more than a defined percentage of the fund—should be subject to a variable net-asset value that would immediately reflect losses from credit events. The defined percentage should be determined after careful analysis. The fund's price should be reported at the end of the day, just like other kinds of mutual funds.

But resolving the tax and accounting issues that arise upon switching to a variable net-asset value system is critical. In today's environment, operating at a static $1 net-asset value, investors can sell shares as often as they need from a money-market fund each day without creating taxable events. This simplicity is central to a money-market fund's usefulness. Variable net-asset valuation creates taxable events for every transaction, adding enormous complexity.

Retail prime money-market funds, in which all shareholders have less than a determined percentage of shares, should be permitted to maintain their stable $1 per share price. But they should be subject to additional oversight, including enhanced transparency and disclosure standards. As a manager of both types of funds, Charles Schwab realizes this will considerably complicate the business model. But the company believes it is manageable—and a compromise on the issue of variable net-asset value is necessary for the good health of our industry and the economy.

Mr. Bettinger is president and chief executive officer of the Charles Schwab Corp.

Credit Union National Association
CUNA

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99 M Street SE
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June 26, 2018

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown,

On behalf of America's credit unions, thank you for holding the hearing "Legislative Proposals on Access to Capital." The Credit Union National Association (CUNA) represents America's credit unions their 110 million members. As you consider ideas to enhance consumers' access to capital, we urge you to consider two proposals pertinent to credit unions.

Delay NCUA's Risk-Based Capital Rule

Credit unions throughout the United States have expressed their significant concerns regarding the National Credit Union Administration's (NCUA) risk-based capital standards for credit unions. These concerns relate both to the appropriateness of the regulatory burden this regulation imposes on credit unions as well as whether NCUA has the legal authority to impose a risk-based standard for determining whether a credit union is well-capitalized when the Federal Credit Union Act permits the NCUA to impose a risk-based standard solely to determine capital adequacy.

NCUA's rule imposes new regulatory burden on credit unions that the agency has failed to justify, and the rule represents a solution in search of a problem. The current Prompt Corrective Action (PCA) system served very well during that crisis, with relatively few credit union failures. If a goal of a PCA scheme is for covered institutions to hold sufficient capital to withstand a severe financial crisis without imperiling the deposit insurance fund, credit unions' performance during the recent financial crisis stands as compelling evidence that a major overhaul of current credit union capital requirements toward a Basel-style system is simply not required. Credit unions failed at roughly one-third the rate of banks over the decade since the beginning of the financial crisis. In addition, credit union failures were generally confined to small institutions: total assets in failed credit unions are equal to only 2% of the assets in failed banks. Further, our analysis shows that risk-based standards applied to credit unions would have done very little to reduce costs to the National Credit Union Share Insurance Fund (NCUSIF) had it been in effect during the most recent financial crisis.

NCUA lacks the legal authority to set a risk-based capital standard to determine whether a credit union is well capitalized, and coming out of the financial crisis, Congress did not convey this authority. During consideration of the Dodd-Frank legislation, Congress explicitly excluded credit unions from risk-based capital requirements, in recognition of the credit union difference and the fact that America's credit unions—nearly half of which employ fewer than five full-time employees and hold less than $20 million in assets—were neither responsible for nor participatory in the risky financial activities that predicated the 2008 financial crisis.

NCUA finalized a rule that addresses a problem that does not exist using authority it does not have. We urge the Committee to address this situation by passing legislation to delay the implementation of NCUA's risk-based capital rule for two years to prevent credit union capital from being unnecessarily impaired to comply with this rule, and to give the agency time to revise these requirements consistent with law and the risk-profile of the credit union system.

Eliminate Maturity Limits on Federal Credit Union Loans

Credit unions could do more to provide access to capital if Congress eliminated statutory restrictions on the maturity of loans made by federal credit unions. While federal credit unions are permitted to make mortgage loans with maturities of more than 15 years, most other federal credit union loans must have maturities of 15 years or less. This puts federal credit unions at an unnecessary disadvantage relative to many state chartered credit unions and other depository institutions. It also makes credit less available for federal credit union members because it complicates both credit unions' ability loan to some education borrowers and to sell certain loans into the secondary market. Eliminating the statutory restriction on federal credit union loan maturity would help credit unions deliver more safe and affordable loan products to their members. We encourage Congress to eliminate these maturity limits for federal credit unions.

On behalf of America's credit unions and their 110 million members, thank you for your consideration of our views and for holding this important hearing.

Sincerely,

Jim Nussle
President & CEO

COALITION
FOR INVESTOR CHOICE INC.

Preserving Money Market Funds for Public Infrastructure Investment and Economic Growth

S. 1117, the Consumer Financial Choice and Capital Markets Protection Act Background and Explanation

June 21, 2018

Summary

S. 1117, the Consumer Financial Choice and Capital Markets Protection Act of 2017 amends the Investment Company Act (ICA) of 1940 to expressly provide any open-end investment company that is a money market fund that relies on the Securities and Exchange Commission's (SEC) Rule 2a-7 with the choice to operate as a stable net asset value (NAV) money market fund if it adheres to certain requirements and restrictions. The legislation would not have any impact on the other changes to the regulation of money market funds (other than the applicability of the mandatory liquidity fees provision) that were adopted by the SEC in 2010 and 2014. S. 1117 also prohibits Federal Assistance to any money market fund.

Background

Congress broadly addressed the regulation of the mutual fund industry in the ICA more than 75 years ago, among other things, to define open-end investment companies, establish federal regulation of them and require their registration with the Commission. The ICA has never expressly addressed the category of mutual funds known as "money market funds."

Since the 1970's, money market funds have grown to become a popular consumer and institutional investment vehicle. Since their inception, until October 2016, all funds were permitted by SEC rule to maintain a stable NAV (typically of $1.00 per share), rather than calculating daily NAV based on the value of the fund's underlying portfolio securities. In 1983, the SEC adopted Rule 2a-7 under the ICA to codify the conditions under which an investment company would be permitted to operate as a money market fund.

Basis for Using Amortized Cost Accounting

Money market funds historically have priced their shares at $1, a practice that facilitates their widespread use by corporate treasurers, municipalities, individuals, and many others who seek the convenience of low-risk, highly liquid investments. This share pricing convention, which uses amortized cost to produce a stable net asset value (NAV), is preferable to mark-to-market pricing, which produces a floating NAV, because amortized cost provides a more efficient and accurate means to value portfolio assets held by funds that operate as cash pools.

Until implementation of the SEC's 2014 Amendments to Rule 2a-7, all money market funds were permitted to use amortized cost to maintain a stable NAV "only so long as the board of directors believes that it fairly reflects the market-based net asset value per share." Funds were required to estimate and make public their market-based NAV per share (known as its "shadow price") each week and the fund board was required to monitor the deviation between the shadow price and $1 at each regular meeting.

Money market portfolio assets are typically held to maturity and trade very infrequently. In addition, the maturity, credit quality, and liquidity restrictions in Rule 2a-7 ensure that any deviation between market value and amortized cost generally is immaterial. Rather than improve the quality or accuracy of the valuations of the individual portfolio assets, the pool as a whole, or the pricing of units of the pool, the floating NAV rule complicates and slow down the process for establishing unit values, thereby delaying settlement of fund unit purchases and redemptions.

The widespread use of money market funds by large and small institutional investors is not practicable without a stable $1 per share value characteristic. The ability of funds to offer their shares at a stable NAV using the amortized cost method of valuation provides significantly administrative and accounting cost benefits for both fund companies and short-term cash management investors.

2010 and 2014 Amendments

In 2010, the SEC adopted a series of revisions to Rule 2a-7, with the intention of making money market funds resilient to the kind of market disruptions that occurred in 2008. Among other things, the 2010 Amendments require money market funds to have a minimum percentage of their assets in highly liquid securities so that those assets can be readily converted to cash to pay redeeming shareholders. They also shortened the average maturity limits to limit the exposure of funds to certain risks such as sudden interest rate movements. As a result, 30 percent or more of a money market fund's portfolio assets are required to mature in a week or less, and their weighted average portfolio maturity is required to be 60 days or less.

In July 2014, the SEC again amended Rule 2a-7. Under the 2014 Amendments the board of directors of a money market fund is authorized to impose a liquidity fee and/or a redemption gate if the fund's weekly liquid assets fall below 30 percent of its total assets under certain conditions. In addition, if the level of a money market fund's liquid assets were to drop below 10 percent of its total assets, the fund (other than a fund that limits its investments to government securities, or a "government fund") would be required to impose a 1% liquidity fee unless its board of directors determines that imposing a fee would not be in the best interests of the fund or that a lower or higher fee that would be appropriate ("Mandatory Liquidity Fees Provision"). These provisions are referred to collectively as the "2014 Fees and Gates Provisions."

The 2014 Amendments also provide that, as of October 14, 2016, money market funds (other than government funds) that are available to investors other than "natural persons" are no longer permitted to operate on a stable NAV basis, and instead are required to use a floating NAV.

Explanation of S. 1117

S. 1117 does not have any impact on the requirements regarding the operation of money market funds imposed by the 2010 Amendments. Nor would the legislation have any impact on the 2014 Gates and Fees Provisions other than the Mandatory Liquidity Fees Provision.

Under S. 1117, a fund may continue to operate as a floating NAV fund unless its board of directors elects to operate as a stable NAV fund. In other words, any open-end investment fund may operate as a money market fund that computes its price per share under the stable NAV approach historically contained in Rule 2a-7 without regard to the identity of its investors, provided that it meets the following requirements:

a. The fund's investment objective must be the generation of income and preservation of capital through investment in short-term, high-quality debt securities; and

b. The fund's board of directors must determine, in good faith, that:

(i) it is in the best interests of the fund and its shareholders to operate on a stable value NAV basis;
(ii) (ii) the money market fund will continue to operate on that basis only as long as the board of directors believes it fairly reflects the fund's market-based NAV; and
(iii) (iii) the fund will comply with quality, maturity, diversification, and liquidity requirements, including reasonable procedural and recordkeeping requirements that are required under Rule 2a-7, or any other rules or regulations that the SEC may prescribe or has prescribed as necessary or appropriate in the public interest or for the protection of investors that are not inconsistent with the legislation.

S. 1117 would further provide that any money market fund that makes a stable NAV election is not subject to the Mandatory Liquidity Fees Provision.

The legislation also prohibits "Federal Assistance"[1] from being provided directly to any money market fund, regardless of whether it operates as a stable NAV or a floating NAV fund. To underscore that money market funds and their investors understand that money market funds will not be eligible to receive Federal Assistance under any circumstances, money market funds would be required to disclose this prohibition in any prospectus, advertising, or sales literature. S. 1117 provides the SEC with the authority to adopt rules and issue orders prescribing the manner in which such disclosure shall be provided, after consulting with the Board of Governors of the Federal Reserve System, the FDIC, and the Department of the Treasury.

Finally, S. 1117 specifically provides that any company that makes a stable NAV fund election will remain subject to all the provisions of the ICA and the rules and regulations of the SEC that would otherwise apply to the company, as long as those provisions do not conflict with the legislation.

Need for the Legislation

When the SEC's 2014 Amendments went into effect in October 2016, they caused approximately $1.2 trillion of private sector liquidity – roughly 80% of prime and municipal money fund balances – to be shifted to U.S. government funds, which were allowed to maintain a stable NAV.

The 2014 Amendments did nothing to reduce systemic risk in the financial system. Instead, it inflicted huge costs on municipalities and businesses in the form of higher borrowing costs and lower returns on invested cash. State and local governments, which had relied on money market funds as a source of

[1] "Federal Assistance" means Federal Deposit Insurance Corporation ("FDIC") insurance or guarantees; transactions involving the Secretary of the Treasury; or the use of any advances from Federal Reserve credit facilities that are not part of a program of broad-based eligibility established in unusual or exigent circumstances – for the purpose of (i) making any loan to, or purchasing any stock, equity interest, or debt obligation of, any money market fund, (ii) guaranteeing any loan or debt issuance of any money market fund, or (iii) entering into any assistance arrangement, loss sharing or profit sharing with any money market fund.

short-term financing and as a safer place than banks to hold large seasonal cash balances, have been greatly harmed in their ability to manage their cash flows, and have been exposed to greater risks as a result. It is resulting in lost revenues that could be available to invest in schools, affordable housing, public infrastructure, and economic development.

S. 1117 would roll back the harmful provisions of the 2014 Amendments by allowing state and local governments and businesses to invest cash balances in non-government money market funds and raise short-term funding from those funds as they had for five decades prior to 2016.

S. 1117 has the support of organizations representing a broad spectrum of public and private sector finance officers and entities, including:

American Association of Metropolitan Water Agencies
American Public Power Association
Association of Financial Professionals
Association of School Business Officials International
Government Finance Officers Association
Large Public Power Council
National Association of Corporate Treasurers
National Association of Counties
National Association of Health and Educational Facilities Finance Authorities
National Council of State Housing Agencies
National League of Cities
State Financial Officers Foundation
U.S. Conference of Mayors

Frequently Asked Questions

1. **Does the legislation roll back any of the SEC's reforms to money market funds in 2010 that strengthened them in response to the 2008 financial crisis?**

   Long before the SEC's 2014 Amendments to Rule 2a-7, and even before the enactment of the Dodd-Frank Act, the 2010 Amendments were adopted to strengthen money market funds against any future financial crisis. The 2010 amendments increased the already high credit quality of the assets held in money market funds, and increased the already high liquidity of such funds by requiring them to have a minimum percentage of their assets in highly liquid securities so that those assets can be readily converted to cash to pay redeeming shareholders. The 2010 Amendments also increased transparency by requiring money market funds to regularly disclose their "shadow prices" (i.e., their portfolios' per-share values at market prices). S. 1117 does nothing to alter those amendments.

2. **What were the reasons the floating NAV rule was implemented in the first place?**

   The floating NAV rule was not intended to create market stability or protect investors; otherwise, it would have also been applied to funds offered to "natural persons" (retail funds), as well as U.S government funds. According to the SEC's adopting release, "[T]he floating NAV requirement is designed to … disincentiviz[e] redemption activity that can result from investors attempting to exploit the possibility of redeeming shares at the stable share price even if the portfolio has suffered a loss …"[2] However, nowhere in the SEC record does the agency cite studies or data suggesting that a floating NAV creates more of a disincentive to redeem than a stable NAV.

The real reason for the rule was to protect the large, systemically risky Wall Street asset managers from FSOC and Federal Reserve oversight. This reason was highlighted in a January 5, 2018, memo from Investment Company Institute President Paul Stevens to the group's Executive Committee. As the memo notes *"Executive Committee members will remember that the SEC adopted the new rules during a period of intense examination of the asset management industry by the Financial Stability Oversight Council as constituted under the Obama Administration. Among other things, FSOC was recommending that money market funds be subject to bank-like regulations, such as capital requirements, and evaluating whether funds or their advisers pose risks to financial stability and should be considered for designation as systemically important financial institutions, enhanced prudential regulation, and supervision by the Federal Reserve Board."*

3. **Some in the money market fund industry contend that the SEC's floating NAV rule has not negatively impacted municipal borrowing costs, so why is the legislation needed?**

Testifying before the Capital Markets Subcommittee in support of H.R. 2319 on November 2, 2017,[3] Pat McCoy, President of the Government Finance Officers Association, which represents 19,000 public finance officers from State and local governments, schools and special districts throughout the U.S., stated:

- "… the impact of the SEC rule on governments is real and it affects not only large governmental entities like mine (New York Metropolitan Transportation Authority), but also small communities throughout the country."

- "Between January 2016 and July 2017, tax-exempt MMFs assets under management fell by 50 percent, from $254 billion to $135 billion, dramatically shrinking an important market for municipal debt. At the same time, municipalities issuing variable rate demand bonds saw their borrowing costs nearly double the Federal Reserve's rate increases over the same period. Many state and local governments determined that issuing variable rate debt to MMFs was excessively costly, and opted to issue higher cost fixed-rate bonds. These increased costs are shouldered by taxpayers and ratepayers."

4. **What evidence exists of long-term market dislocations due to implementation of the SEC's floating NAV rule?**

First, nearly $1.2 trillion has exited prime and tax-exempt funds, and moved into U.S. treasury and government funds, because of the rule. Tax-exempt funds, a key source of funding for state and local governments and their infrastructure projects, experienced a 40 percent decline between January 2016 and April 2018. This caused the SIFMA Municipal Borrowing Index to increase from 1 to as much as 180 bps, or more than double the Fed rate increase on an after-tax basis, over the same period.

Second, state and local governments hold over $190 billion of assets in MMFs.[4] Because of the rule, the only money market fund options available to state and local governments are those that invest solely in U.S. government debt. They are no longer able to invest their short-term cash in prime funds, which have always been a safe investment providing a market rate of return. According to a

[2] https://www.sec.gov/rules/final/2014/33-9616.pdf
[3] https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-pmccoy-20171103.pdf.
[4] See https://www.federalreserve.gov/releases/z1/20180607/z1.pdf, page 84.

report by BlackRock, "prime money market mutual funds have consistently yielded 30 basis points more than government money market mutual funds since the beginning of 2017."[5] As a result, state and local governments were prevented from taking advantage of over $500 million in additional investment earnings that would otherwise have been available, and had to be made up through reduced services or higher taxes.

Third, main street businesses have been severely impacted. Large, highly rated corporate borrowers have easily replaced the $161 billion they lost from prime funds with bank borrowings. The shortfall burden, however, fell on the shoulders of main street businesses. They have been crowded out of bank lending by the larger companies. Some Main Street firms now pay higher rates to alternative lenders; others are simply unable to borrow at any competitive rate. According to a study by Treasury Strategies[6], for each $1 billon of prime money market fund debt that a large company replaces with bank borrowing, 10,000 main street businesses lost access to $100,000 in funding.

5. The fund industry incurred enormous costs to implement the SEC rule. Isn't it unfair to change some aspects of it so soon before the industry has had time to "recover" its investment?

According to a study by Treasury Strategies[7], total one-time implementation costs ranged from $120 - $200 million, and all of those costs were passed on to the end-users through fees. Also, this is an insignificant part of the $4.8 billion in annual expenses that the industry passed through to its customers last year, and it is an insignificant part of the $2 billion in annual yield which investors are losing each year on their investments in government funds vs. prime funds.

6. If there is little material difference between a floating NAV and a stable NAV when it comes to money market fund valuations, why don't state and local governments and other institutional investors simply change their investment policies?

Underlying this argument is a fundamental misunderstanding of investment policies. Such policies establish general investment goals and objectives, and describe the strategies that finance officers should employ to meet these objectives. If municipalities and other institutional investors are going to change their investment policies to fit the products they want to invest in, then why have a policy process at all?

7. The primary reason that investors fled floating NAV prime and tax-exempt funds is because of the redemption gates and liquidity fees. Does S. 1117 address that issue?

The stable NAV is an essential element of the utility of the MMF product to the investor. Liquidity fees and redemption gates do raise additional concerns. S. 1117 addresses a large part of this concern by enabling funds to elect out of mandatory liquidity fees that were part of the 2014 Amendments. Institutional investment policies emphasize preservation of principal and access to liquidity, and mandatory liquidity fees violate those principles.

Notably, since enactment of the ICA 1940, and with that statutory enabling enhanced under the 2010 Amendments, all mutual funds are permitted to suspend redemptions and postpone payment of redemption proceeds. That discretionary authority, which exists to protect shareholders, has never deterred investors from using money market funds.

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[5] See https://www.blackrock.com/investing/financial-professionals/defined-contribution/news-insight-analysis/dc-and-money-market-funds
[6] www.treasurystrategies.com/wp-content/uploads/2017/11/NegativeImpactsOfNewUSMoneyMarketFund.pdf
[7] www.treasurystrategies.com/industry_insight/the-cost-of-implementing-the-2016-mmf-regulations/

8. Before enacting S. 1117, shouldn't the SEC conduct a study of the long-term impact of the 2014 Amendments and report back with recommendations?

The SEC did perform a study before adopting the 2014 Amendments. Four years after adoption and 20 months since the loss of stable-value nongovernment funds, the effects are clear and the SEC's study and anticipated impact was wrong. The permanent disruptions to our short-term capital markets are real and irrevocable short of restoring the stable NAV, hurting both municipal and business borrowers alike. That's because the operating features of a floating NAV make non-government funds unworkable for cash management applications, as stated by virtually every commenter on the proposed rule. For example:

- Sweep Accounts were rendered inoperable by the floating NAV. These popular operating accounts simply cannot work without a stable share price.

- Floating NAVs and mandatory liquidity fees are not permitted under many institutional investment policies, including those of most state and local governments. Such policies are black and white; investments which do not meet minimum policy requirements may not be used under any circumstances.

- Floating NAVs and mandatory liquidity fees are not permitted by many loan covenants and bond indentures. In the past, many loan and bond proceeds were invested in prime money market funds.

- Tax and recordkeeping requirements raise excessive operational costs to investors in prime and tax-exempt funds.

9. Money market funds are not bank products. But many investors believe they provide the equivalent of federally insured bank products. Wouldn't a floating NAV make that more apparent?

Confusion about whether such funds are government insured may be true for retail investors, but retail funds are not required to comply with the floating NAV. Only institutional investors in prime and tax-exempt funds are covered, and no financial officer for a company or municipality is unaware of the fact that money market funds are not bank-like products.

10. Isn't a floating NAV more transparent because it reflects the actual value of the underlying assets, whereas the stable NAV hides the true value of risky assets to investors?

The SEC's 2010 Amendments already require the publication of "shadow prices" based on a floating NAV. Those shadow prices show that a floating NAV does not materially provide more transparency than a stable NAV. That's because money market funds invest in short-term securities representing high-quality, liquid debt that is held to maturity. (They do not, and have never, invested in "risky" assets.) Under the 2010 Amendments, 30 percent or more of a fund's portfolio assets must mature in a week or less, and their weighted average portfolio maturity must be 60 days or less. Today, total weekly liquidity in prime funds is 51 percent, and total daily liquidity is 32 percent[8]. To show any variability, the 2014 Amendments require prices to be rounded to the nearest 1/100th of one cent (or four decimal places).

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[8] https://www.sec.gov/divisions/investment/mmf-statistics/mmf-statistics-2018-05.pdf, page 9.

In the case of the Reserve Fund breaking the buck in 2008, a floating NAV would not have provided any additional transparency. Shareholders would have experienced exactly the same losses as occurred under the stable NAV. That's because the Lehman commercial paper held by the fund was "marked to model," and the pricing services had not discounted the paper prior to the bankruptcy. Therefore, on the business day before the Lehman bankruptcy, a floating NAV of the Reserve Fund would have been substantially the same as the stable NAV.

If anything, a floating NAV may contribute to less transparency by forcing investors seeking a market rate of return on short-term liquidity to move their cash into non-regulated funds and riskier products. And for municipal borrowers who lost access to money market funds, but still want to benefit from the yield curve, riskier interest rate swaps have become more appealing.

11. Why not just exclude tax-exempt funds from the floating NAV rule as a way to address the impact on state and local governments?

Excluding just tax-exempt funds from the floating NAV rule would not address problems for municipalities both as investors and as issuers of debt. According to the Government Finance Officers Association[9]: "Restoring the stable NAV for both prime and municipal money market funds will restore the ability of state and local government to access permissible funds for investing their operating cash. In addition, it will lower short-term funding costs for municipalities by increasing overall liquidity in the market." GFOA explains that state and local governments depend on the safety and stability of prime money market funds, how they need both prime and tax-exempt funds to finance infrastructure and economic development, and that they look to both prime and tax-exempt funds for disaster recovery efforts.

12. Don't the 2014 Amendments protect municipalities by forcing them to shift their operating cash from risky investments (prime and tax-exempt funds) to less risky investments (U.S government funds)?

By design and regulation, prime and tax-exempt money market funds are only permitted to invest in the very highest quality, short-term fixed income securities that are largely held to maturity and do not have material fluctuation due to either market, interest rate or credit risk. There is no safer product available for cash management other than an insured bank deposit. By forcing municipal investors out of prime and tax-exempt funds and into government funds, the SEC's floating NAV rule has increased costs on taxpayers and businesses without any material benefit.

13. The SEC went through a rigorous rulemaking process. Why should Congress second-guess those who have the duty and expertise to ensure our financial markets are functioning properly?

It is always good to be skeptical of legislative efforts to overturn regulatory actions. But sometimes the regulators get it wrong, and Congress needs to step in and right the wrong. In the case of money market funds, the SEC laid out a theory that suggested that the benefits of a floating NAV would exceed the costs to investors and issuers. Twenty months into implementation of the rule, there is no evidence to suggest that theory is correct, and plenty of evidence to prove it wrong.

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[9] http://protectinvestorchoice.com/wp-content/uploads/2018/01/How_Municipalities_Depend_on_Prime_MMFs-GFOA.pdf

Friday, June 29, 2018

OPINION

State and local governments need Congress to fix one more mistake from financial reform

by Ron Crane | June 21, 2018 12:00 AM

Rules designed to contain bad actors on Wall Street instead frustrated creditworthy consumers and local governments.
(iStock)

Last month, an impressive bipartisan majority in Congress acknowledged what has long been obvious to most Americans: Some of the reforms enacted in the wake of the financial crisis of 2007-2008 went too far.

Rules designed to contain bad actors on Wall Street instead frustrated creditworthy consumers and small business owners on Main Street who need access to capital to invest in the American Dream. The bill President Trump signed into law was a significant but incomplete step in correcting that regulatory overreach.

Another key regulation that needs to be fixed is a Securities and Exchange Commission, or SEC, rule enacted during the waning days of the Obama administration that put sharp restrictions on money-market mutual funds. The rule eliminated the use of stable net asset value, or NAV — the dollar-per-share valuation of nongovernment money market funds — in favor of a floating NAV valuation system that makes them impractical for state and local governments to use. This may seem like an obscure and hard-to-explain finance issue, but consider this: The change has caused more than $1 trillion of private sector liquidity to shift away from funds that invest in the economic infrastructure of our communities and into funds that invest strictly in U.S. government debt.

Despite the clear harm caused by the rule, the largest Wall Street asset management companies want you to believe the rule is a good thing. Well, it is for them, but it isn't for state and local taxpayers, main street businesses, and other drivers of economic development and job creation.

State and local governments, nonprofit hospitals, public schools, and universities, transportation agencies and economic development authorities are just a few of the institutions serving our communities that rely on money market funds as a source of low-cost financing, and as a tool for managing large cash flows. Because of the SEC rule, their financing costs have spiked far above the Federal Reserve's rate increases over the past two years. And they have lost the ability to earn market rates of return on the investment of operating cash.

These additional costs and reduced incomes are straining budgets and creating upward pressure on tax rates. State and local governments have to make up that difference by finding new sources of revenue, or scaling back investments in schools, affordable housing, public infrastructure, and other important services to their residents.

Thankfully, there's growing momentum in Congress for a solution. Earlier this year, the House Financial Services Committee passed bipartisan legislation to roll back the harmful 2016 changes to money fund rules. The measure, H.R. 2319, would give institutions like state and local governments, businesses, pension funds and nonprofit organizations the freedom to invest cash balances in prime money and tax-exempt money market funds, which can in turn invest in things our communities need to maintain economic growth. The Senate Banking Committee will consider similar legislation (S. 1117) at a hearing on June 26.

In the face of this momentum, several Wall Street firms that backed the SEC rule to avoid regulatory scrutiny of their own businesses practices in the wake of the financial crisis, are actively working to prevent enactment of this legislation, which is supported by over 400 national state and local officials and organizations representing municipalities, main street businesses, building trades, and nonprofit organizations.

In the past 10 years, money market fund investors and borrowers have twice become victims of Wall Street's excess; first by a financial crisis that devastated communities and, second, by having to pay the price for a backroom deal that protects large financial companies from oversight designed to prevent a repeat of 2008.

The Trump administration and Congress can right this wrong by enacting legislation to restore the ability of money market funds to support the infrastructure and economic development needs of our states and communities by returning to a stable net asset value for money market funds.

Vanguard®

Money market fund reform and municipal issuers

June 2018

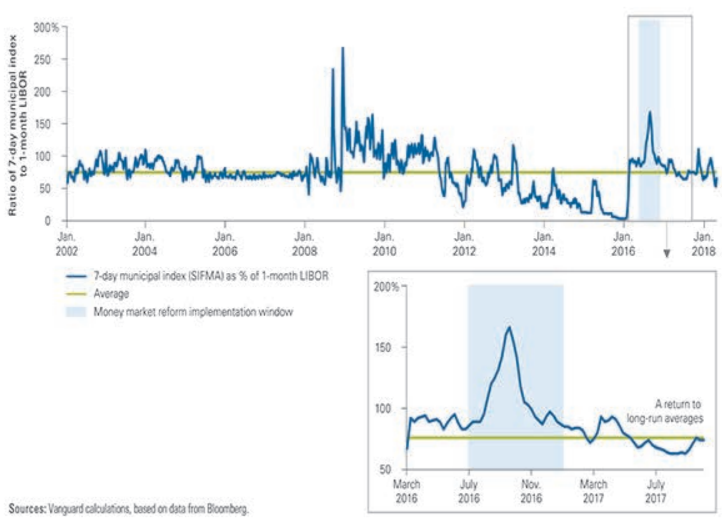
Has money market reform had a meaningful, lasting impact on municipal market interest rates?

No, the impact was temporary. The Securities and Exchange Commission's money market reforms became effective on October 14, 2016. In the months leading up to implementation, the municipal money market industry saw a decline of nearly 50% in assets under management. The resulting outflows from money market funds caused a period of excess supply in the municipal variable-rate demand note market. This imbalance in the market drove interest rates on the 7-day SIFMA index (average weekly variable funding rate for a municipal issuer) higher than comparable taxable money market interest rates. However, **this dislocation in municipal yields was short-lived and borrowing costs normalized** as an influx of demand from taxable money market funds and other types of short-term municipal investors helped to quickly drive the market back to historical norms. Demand appears not to have left the municipal market; rather, investors are accessing the market through different investment vehicles.

Further, the relationship between municipal and taxable money market interest rates has returned to historical averages. Variable-rate demand note interest rates (the primary short-term funding mechanism for municipal issuers) have settled back in at levels approximately in line with historical observations **(Chart 1)**.

In the case of 1-year municipal notes (a key source of cash-flow financing for municipalities), shifts in demand have benefited municipal issuers. The ratio of 1-year municipal interest rates relative to 1-year U.S. Treasury rates is currently lower than the historical average of this relationship.

Chart 1. Municipal variable-rate yields have returned to long-run averages relative to taxable alternatives

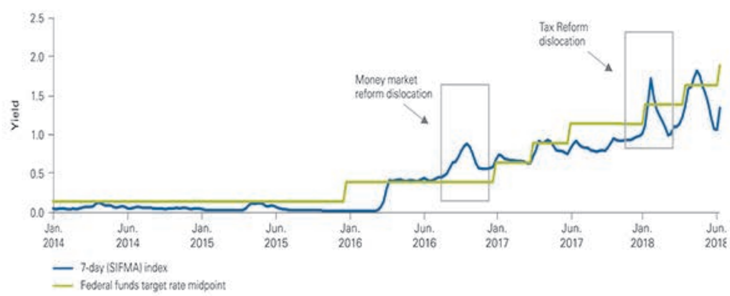


Sources: Vanguard calculations, based on data from Bloomberg.

If money market reform isn't responsible for higher interest rates, then why are municipal interest rates higher?

The sustained rise in short-term municipal funding rates has primarily been driven by increases to the federal funds rate by the Federal Reserve's Federal Open Market Committee (Chart 2). The FOMC, in keeping with their intended current monetary policy, has increased the target rate by 25 basis points on seven separate occasions starting in December 2015 for a total increase of 1.75%. The coincidental timing of these increases and of money market fund reform has led to misidentification of the true causation of higher municipal yields.

Chart 2. Sustained rise in short-term municipal interest rates has been driven by Federal Reserve hikes, not money market reform



Sources: Vanguard calculations, based on data from Bloomberg.

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LETTERS AND STATEMENTS SUBMITTED BY SENATOR BROWN

Vanguard

Money market fund reform and municipal issuers

June 2018

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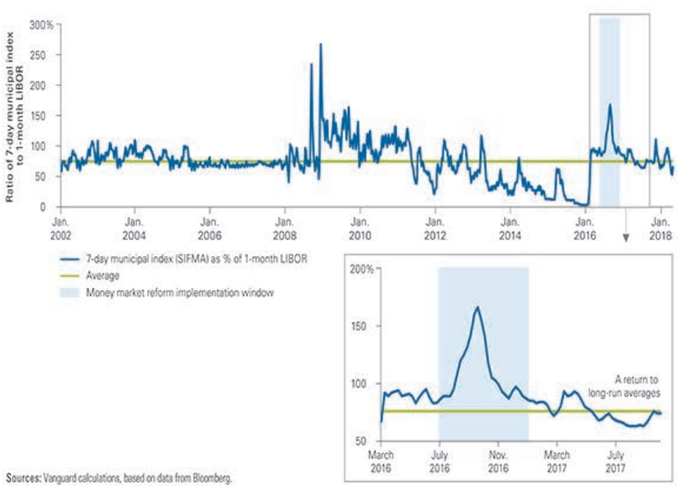

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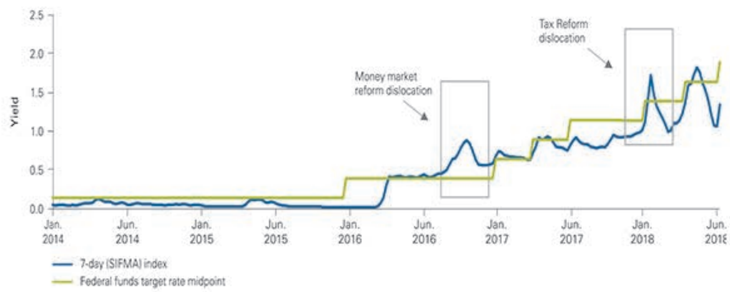

Sources: Vanguard calculations, based on data from Bloomberg.

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April 16, 2018

Roxanne S. Austin
Chair of the Compensation Committee
Abbott Laboratories Board of Directors
c/o Abbott Corporate Secretary
Abbott Laboratories, Dept. 364, Bldg. AP6D
100 Abbott Park Road
Abbott Park, IL 60064-6400

Dear Ms. Austin,

I am writing in connection with your letter (the "Abbott Letter") to the shareholders of Abbott Laboratories ("Abbott"), contained in Abbott's Schedule 14A filed with the SEC on April 5, 2018. The Abbott Letter relates to the Proxy Analysis report (the "ISS Report") issued by Institutional Shareholder Services Inc. ("ISS") to its clients, in connection with Abbott's upcoming annual meeting of shareholders on April 27, 2018.

The Abbott Letter claims to "highlight and correct substantial errors in analysis and fact" purportedly made by ISS in the ISS Report. Given the severity of the accusations in the Abbott Letter and ISS' fundamental disagreement with the assertions, we felt it was important to communicate with you directly on these matters. I will address each of the main complaints from the Abbott Letter below in more detail, but let me start by saying in summary that all the main assertions made in the Abbott Letter about the ISS Report are either misinformed or plain incorrect, and we are surprised that such a mischaracterization was sent by Abbott to its shareholders. The Abbott Letter itself contains a number of serious factual errors and misrepresentations about both the ISS Report and the process undertaken by ISS in the preparation of the ISS Report, including its engagement efforts with Abbott.

Below I've taken the liberty of extracting from the Abbott Letter the key accusations and assertions made, and following each of those extracts I've provided ISS' substantive response. I have numbered them for easier reference, but would note that they are not so-numbered in the Abbott Letter.

1. ***Abbott Letter: "ISS is aware of the flaws and inaccuracies in its Report and has disregarded our attempts to correct them. Attached as Annex A is the detailed letter sent to ISS correcting their errors, omissions and misrepresentations."***

ISS Response: ISS is not aware of any flaws or inaccuracies in the published ISS Report, and certainly has not disregarded any attempts to correct any errors. To the contrary, in response to Abbott's April 3 letter to ISS (the letter referenced above as Annex A), ISS corrected the two factual inaccuracies Abbott identified in the draft report which was provided to Abbott as part of our "draft review" process for companies in the S&P 500 index. Those two factual inaccuracies were identified in Abbott's April 3 letter to ISS and we of course corrected them before publishing the final version of the ISS Report to our clients. This is precisely the goal of our draft review process, namely to help ensure the accuracy and quality of our reports for the benefit of our institutional investor clients for whom the reports are prepared. While Abbott's April 3 letter did identify a number of other areas that we understand Abbott considers to be flaws and inaccuracies, in fact those other areas reflected differences of opinion or disagreements by Abbott with the methodologies

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that ISS applies. These methodologies are made available publicly, are consistently applied in the ISS models and research, and have been correctly and fairly applied within the ISS Report.

While Abbott is obviously free to disagree with the philosophical approach of ISS (or of any research provider or shareholder for that matter), and ISS acknowledges that there is room for open-minded debate on various corporate governance policies and assessment methodologies, a disagreement in philosophy or approach does not constitute an error, omission or misrepresentation.

2. ***Abbott Letter:*** ***"Additionally, we made multiple requests to ISS for a meeting to discuss the Report. Contrary to their stated policies, however, ISS refused to engage and proceeded to publish a flawed and inaccurate Report".***

ISS Response: ISS is always happy to consider engagement requests, as you should be aware from our in-depth engagement with Abbott in advance of the company's 2017 shareholders meeting. However, Abbott did not make multiple requests for engagement this year. In fact there was only one request for a meeting to discuss the ISS Report, and ISS responded to this request on the same day in a manner fully consistent with our policies.

As part of our draft review process, Abbott submitted its written comments on the draft ISS Report on April 3rd. Once received, our analysts considered the company's extensive commentary, identified that most of the alleged errors were based on disagreements about our stated methodology rather than being errors of fact or omission, and identified two items that were factual inaccuracies (the date Abbott entered into the agreement to acquire Alere was incorrectly noted in the draft, and the start year of the company's audit firm was confirmed by Abbott to be 2014 rather than 2013). In addition to some other adjustments to our analysis which were made based on Abbott's feedback, these two factual corrections were made before the ISS Report was finalized and sent to our clients.

The "multiple requests" for engagement mentioned in the Abbott Letter were in reality one request for an engagement meeting following the company's provision to ISS of its April 3 written comments on the draft Report. This request was received from Jessica Paik of Abbott on April 4th, and ISS responded on the same day to let Abbott know that the company's comments were being reviewed, that we would reach out to the company if we had any questions, and asking the company to let us know if it had any additional comments. Subsequently, our analysts determined that Abbott had provided fulsome comments and feedback and that they had no further questions which would necessitate further engagement at that point.

I should also point out that our decision that no further engagement was necessary at that point was not in any way a violation of our stated engagement policies. To the contrary, in the March 30, 2018 email cover letter ISS sent to John Berry of Abbott when delivering our draft report for review, we noted the following on our policies for full clarity:

Requests for further engagement/follow-up: *[ie. after the submission of the draft Report for fact-checking purposes]*

We do need to receive your written comments before we can determine whether further engagement is necessary, and that determination is at ISS' sole discretion. During proxy season, companies should expect that only truly exceptional situations will warrant engagement immediately prior to, or following, publication of ISS' reports

Our records show no other requests for engagement were received from Abbott in 2018 prior to the delivery of the draft ISS Report to Abbott for review.

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3. ***Abbott Letter:* "In 2017 the Company performed at the top of its peer group with Total Shareholder Return (TSR) growth of 52% and completed all of its financial and strategic objectives. The CEO was granted LTI in 2017 at the 23rd percentile of our peer group. Abbott improved over 35 points on ISS' Key Relative Degree of Alignment test and achieved an overall "low concern" outcome on ISS' quantitative tests. It is absurd that in the face of these facts that ISS has not recommended support for Say-On-Pay. ISS's recommendations should be objective and based on facts."**

ISS Response: The basis of the ISS vote recommendation on the "Say-on-Pay" item is clearly stated in the ISS Report, and is neither an issue with Abbott's performance nor with the amount of the CEO's pay and equity grants. The "against" recommendation was driven by concerns (1) regarding the design and structure of the incentive plan and a lack of transparency of metrics and goals, and (2) that the long-term program awards are too heavily influenced by short-term TSR performance. We also note that ISS' quantitative assessment of the compensation program resulted in an overall "medium concern", not an overall "low concern" as you state in the Abbott Letter (see page 14 of the ISS Report).

In any event, ISS' analysis of, and vote recommendations on, Say-on-Pay agenda items are based on both qualitative and quantitative factors. ISS conducts an analysis of the pay programs and practices for all companies, and an enhanced review is conducted for all companies that exhibit an elevated overall concern (Medium or High) on the quantitative screen, and for a selection of companies that exhibit a Low overall concern level from the model.

With respect to the company's specific comment that, "Our CEO was awarded LTI at the 23rd percentile of our peer group in 2017, while our Company performed at the top of our peer group with a TSR of 52%", ISS does not dispute this statement. It does not, however, mitigate the structural and transparency concerns identified in our qualitative review.

4. **Abbott Letter: *"Instead, ISS's recommendation on executive pay is driven by:***

   - ***Manipulation of our peer group—ISS altered the Company's peer group and selected inappropriate peers which do not reflect the impact of Abbott's significant increase in size following two significant acquisitions, St. Jude and Alere, during 2017. ISS added peers which do not even meet their own criteria and omitted Company selected peers if they paid relatively high while performing relatively low, thus purposely manipulating the outcome. "***

ISS Response: These assertions are wholly without basis. ISS-selected peers are not a "manipulation" of the company's peer group, and there has absolutely been no "manipulation" of the ISS-selected peer group to Abbott's detriment. In fact, the only alterations to the initially-selected ISS peer group have been to take account of the acquisitions made by Abbott in 2017, which adjustments were made after considering the information Abbott provided to ISS.

As a starting point and to confirm what I believe Abbott already knows, ISS' policy approach provides for the creation of an ISS-selected peer group for every company, and this is based on an algorithmic-driven approach. ISS' methodology for its peer group determinations is made available publicly and is used consistently without prejudice. Our peer selection methodology considers the market capitalization, revenue, and industry of a company and its peers, and does not take into account relative shareholder returns or CEO pay at any point in the process, as the Abbott Letter alleges. The purpose of using ISS-selected peer groups is to provide objectivity in peer selection and consistency amongst companies for the purpose of our quantitative analysis of pay for performance. ISS' peer selection for Abbott adhered to our methodology, and also appropriately took into account the acquisitions made in 2017 based on information provided by Abbott.

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The ISS peer group for the ISS Report was first generated based entirely on our peer selection algorithm, which fully considered Abbott's 2017 peer group as submitted by the company to ISS during the "peer feedback" process. This algorithm-selected peer group already had significant overlap with the company's self-selected peer group. Abbott then reached out to ISS in early March 2018 asking that we consider the acquisitions that the company had made during 2017, and the impact of those acquisitions on Abbott's market cap and revenue as it relates to our peer group selection. After considering the points raised in Abbott's March 1, 2018 letter, ISS determined that it was appropriate to remove one of the peers that ISS' algorithm had selected (Boston Scientific Corporation), and to add an additional company suggested by Abbott and which met ISS' requirements for an appropriate peer (Thermo Fisher Scientific).

Contrary to the assertion that ISS manipulated the peer group to the detriment of Abbott, these updates were made taking into account the information Abbott provided, and resulted in an even greater overlap between the company's selection and the ISS-selected peers. The final peer group used by ISS in the ISS Report had significant overlap with Abbott's self-selected peers (12 out of 16).

5. ***Abbott Letter: "Manipulation of GAAP and non-GAAP measures—ISS selectively uses GAAP and non-GAAP measures during its analysis. When GAAP measures are employed, ISS ignores the one-time impact of U.S. Tax Reform and thereby understates all of Abbott's financial metrics. Although they state EBITDA is the most important measure for our GICS code, they exclude its use. Abbott outperformed all of its Company and ISS peers in EBITDA growth. Inclusion of EBITDA in the analysis would have positively impacted Abbott's scoring. After excluding EBITDA, ISS then claims ROA, ROIC and ROE results are low based on the one-time GAAP-effect of U.S. Tax Reform. With such arbitrary methods, ISS artificially inflates pay and falsely asserts operating performance is lower. Moreover, ISS makes little attempt to explain the composition of, or rationale for use of, those measures."***

ISS Response: There was no manipulation of GAAP and non-GAAP measures in the ISS Report. The measures used in our models and analyses are consistent and transparent, and they were certainly not selectively used "against" Abbott as is implied here. Equally important and as explained above, our vote recommendation on the Say-on-Pay agenda item did not rely upon either the quantitative model results or the operating performance measures quoted by Abbott.

A number of other assertions here are simply incorrect statements of fact - we do not state that EBITDA is the most important measure for Abbott's GICS code nor does "ISS then claim[s] ROA, ROIC and ROE results are low..." In fact, the references to ROE, ROA, and ROIC performance in the **draft** report were removed before the ISS Report was finalized, after taking into consideration the comments provided by Abbott in the April 3 draft review response letter.

6. ***Abbott Letter: "Inflation of CEO compensation—ISS uses a non-GAAP approach to the valuation of option grants which leads to an inflated and incorrect calculation of 3-year average CEO pay. For example, the combination of a 10-year option life (Abbott's average option life is actually 6) with a 3-year volatility assumption purposely overstates the value of the grant the Compensation Committee made, the value of the award the CEO received, the actual expense to the Company and the actual impact on shareholders."***

ISS Response: There was no inflation of CEO compensation in the way that Abbott describes. ISS' Black-Scholes option valuation methodology is clearly explained in our publicly available policy documents and I refer you to FAQ #4 in our U.S. Compensation Policies—Frequently Asked Questions document which is available on our public website at https://www.issgovernance.com/file/policy/active/americas/US-Compensation-Policies-FAQ.pdf.

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The valuations of the option grants to Abbott's CEO were made fully in line with that methodology, in line with our normal process, and we consider them correct and fair.

Regarding option life, ISS is aware and acknowledges that Abbott is using valid, permissible and accepted accounting practices to estimate the life of the options for all employees, and uses the same assumptions for calculating the option term for the CEO for valuation purposes – which we understand is completely consistent with what is allowable under applicable accounting rules. ISS' methodology, however, is based on the different assumption that most executives tend to hold onto their options until close to expiration and there is empirical evidence to suggest this pattern. In looking at the specifics for Mr. White, we see that this holds true – Mr. White tends to hold options for longer than six years. Per Abbott's most recent proxy, for example, he has a tranche of options that was issued over 9 years ago and with less than a year left to expiration.

Regarding volatility, according to a "Radford Review" published by Radford Consulting, which can be found at https://www.radford.com/home/ccg/valuation_services/Whitepaper_ASC_Topic718_Assumptions_Best_Practices.pdf, about 20% of companies use a similar method to calculate volatility as ISS does– that is, basing volatility assumptions on a single historical volatility measurement period (in our case, three years). In the study, Radford states: "In practice, the most frequent categories for determining expected volatility are historical volatility, implied volatility, and peer volatility. Further, many companies elect to use a combination of the above volatility types, also referred to as a blended volatility."

According to the same study, 95% of companies use historical volatility as an input to their volatility assumptions. 70% of companies do use historical volatility in concert with implied or peer volatility; for the strong majority of companies, historical volatility is an important input into their final volatility assumptions.

We believe ISS' methodology is robust and transparent – and is also accepted as a standard, or as a primary component, by many companies.

ISS' treatment of Abbott's options is consistent with our published methodology, has been in place for a number of years (providing year on year consistency), and there are no deviations from our standard valuation methodology in the ISS Report. For full transparency, ISS displays in our research reports both ISS' and the company's assumptions used for CEO option award valuation, as well as the resulting difference (if any) between the two valuations. This information was included in the ISS Report as follows:

Abbott Laboratories (ABT)
POLICY: United States

OPTION VALUATION ASSUMPTIONS

For CEO's last FY Grant	Company	ISS
Volatility (%)*	18.00	20.74
Dividend Yield (%)*	2.40	2.28
Term (yrs)*	6.00	10.00
Risk-free Rate (%)*	2.10	2.42
Grant date fair value per option*	6.54	9.27
Grant Date Fair Value ($ in 000)**	4,100	5,920

*Source: Standard & Poor's Xpressfeed;**Source: DEF14A (company value); ISS (ISS value); Difference between ISS and company grant date fair value is 44.39%

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7. ***Abbott Letter:*** ***"A false claim that our Proxy Filing lacked adequate disclosure—ISS incorrectly claims that our disclosure in our Proxy Filing lacks rigor and specifics. To the contrary our disclosure clearly states the reasons for compensation decisions as well as specific targets and achievement levels, the design of our compensation programs, and provides disclosure on 2018 grants which is not required or provided by most companies. Although we do not publish competitively sensitive strategic goals, the goals themselves are direct, measurable, time-bound and individually assigned to the appropriate executives. They are neither subjective or without rigor as ISS suggests."***

ISS Response: While we understand that Abbott disagrees with our conclusions, ISS believes that its Say-On-Pay analysis in the ISS Report correctly identifies concerns around disclosure. In ISS' view, and as explained in the ISS Report, several incentive metrics and goals are described in overly broad terms, without specific results or weightings on a per-goal basis being disclosed. In other cases, performance results are entirely undisclosed. These concerns are exacerbated by the fact that the strategic and leadership goals accounted for half of the annual incentive award opportunity, and that the award was paid out above target without the company providing its shareholders with adequate information to assess this. We believe our analysis of the incentive programs is correct and reasonable, and it is in line with our established policy and practice.

8. ***Abbott Letter:*** ***"ISS then reaches a conclusion regarding separation of Chairman and CEO based entirely on "concerns" about control of executive compensation that ISS created through its distorted analysis."***

ISS response: Putting aside the efficacy of our analysis on the Say-on-Pay item as discussed in detail above, ISS' recommendation to vote "for" the shareholder proposal for the company to adopt a policy to have an independent chair was not based only on the compensation concerns. When analyzing shareholder proposals seeking an independent chair, ISS' policy approach for U.S. companies is generally to recommend "for" the proposal, while considering on a case-by-case basis the scope of the proposal, company-specific factors, and any other factors that may be applicable (such as compensation concerns).

In addition to referencing the executive compensation concerns, the ISS Report is clear that the scope of this particular proposal is not considered overly prescriptive on the company. This is also a strong supporting factor to our "for" recommendation on the proposal. You will be aware that there was a similar proposal at Abbott's 2017 meeting, and that we also recommended a vote in favor of that proposal last year.

9. ***Abbott Letter: "As explained in our March 1, 2018 and December 11, 2017 letters to Mr. Bimal Patel, your Vice President, U.S. Research, Abbott completed two large strategic acquisitions during 2017 which greatly increased our size and had a substantial impact on our financial metrics. As these letters appear not to have been adequately considered, we have reiterated their contents below. "***

ISS Response: The letters referenced were reviewed and considered in full. As noted above, the issues and information Abbott articulated in its March 1, 2018 letter did result in changes to the ISS peer group selection for Abbott to reflect the acquisitions made. In hindsight perhaps we could have communicated to Abbott directly at that point that we had, in fact, considered and acted upon the March 1, 2018 letter. However we considered that those changes would be fully apparent in the draft report sent to Abbott on March 30, 2018 as part of the draft review process.

10. ***Abbott Letter:*** ***" Substantive reliance on our CEO's 2018 equity award as a basis for concern which is irrelevant to 2017's Say on Pay recommendation, and is provided only as information in advance of next year."***

ISS Response: As described by Abbott itself in its 2018 proxy statement, the 2018 equity award for Mr. White was determined based on performance in 2017, and based on relative TSR for the one-, three-, and five-year periods ending in

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2017. Given this disclosure, while the grant was made in 2018, it was an appropriate consideration in the analysis of the CEO's total pay for 2017. The practice of considering grants made subsequent to the corresponding performance year is routinely applied by ISS for companies that have such a timing lag issue. This point is also explained in the ISS Report.

We would also note that during Abbott's review of ISS' report for the 2017 shareholders meeting, Abbott made the case to ISS at that time that pay decisions made with respect to 2016 performance were reflected in the magnitude of the CEO's 2017 equity grant, and that ISS' evaluation should take this into account. Having accepted Abbott's argument for our 2017 analysis, this approach was also used in the 2018 ISS Report to provide fair and correct consistency.

I hope that the foregoing will be helpful in addressing the concerns and allegations you raised to your shareholders, and in understanding that the alleged "substantial errors in analysis and fact" perceived by Abbott are nothing of the kind. It is also my hope that you will now understand that ISS did not refuse to engage with Abbott in the way that is mischaracterized in the Abbott Letter or contrary to our policies.

While you may not necessarily agree with aspects of our methodologies or our conclusions, I hope you are now more fully informed as to the facts of the disagreements, and of ISS's methodologies and approaches which are applied as consistently and transparently as possible, and without prejudice. If you and other members of the Abbott Board or Compensation Committee would like to discuss further, we would be happy to do so, whether now or in advance of Abbott's 2019 proxy and annual meeting.

If you think it would be appropriate and/or useful, you have our permission to make this letter available to your shareholders.

Yours sincerely,

Georgina Marshall,
Global Head of Research
Institutional Shareholder Services Inc.

cc: Gary Retelny, ISS President and CEO

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May 30, 2018

The Honorable Dean Heller
Chairman
Subcommittee on Securities, Insurance and Investment
Senate Banking, Housing, and Urban Affairs Committee
United States Senate
324 Hart Senate Office Building
Washington, D.C. 20510

The Honorable Mike Rounds
Senate Banking, Housing, and Urban Affairs Committee
United States Senate
502 Hart Senate Office Building
Washington, D.C. 20510

The Honorable Thom Tillis
Senate Banking, Housing, and Urban Affairs Committee
United States Senate
185 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Tom Cotton
Senate Banking, Housing, and Urban Affairs Committee
United States Senate
124 Russell Senate Office Building
Washington, D.C. 20510

The Honorable David Perdue
Senate Banking, Housing, and Urban Affairs Committee
United States Senate
455 Russell Senate Office Building
Washington, D.C. 20510

The Honorable Tim Scott
Senate Banking, Housing, and Urban Affairs Committee
United States Senate
717 Hart Senate Office Building
Washington, D.C. 20510

Dear Senators Heller, Tillis, Perdue, Rounds, Cotton and Scott:

Thank you for your letter dated May 9, 2018. Institutional Shareholder Services Inc. (ISS) welcomes this opportunity to answer your questions, address common misinformation about ISS and proxy advisors, and provide clarity about our business practices and the regulatory requirements to which we are subject.

First, as a general note, ISS is a Registered Investment Adviser ("RIA"). As such, we are subject to the Investment Advisers Act of 1940 ("Advisers Act") and the rules and regulations that the U.S. Securities and Exchange Commission ("SEC") has promulgated thereunder. As an RIA, ISS owes a fiduciary obligation to our investor clients, which means ISS and our employees must carry out our duties solely in the best interests of clients and free from any compromising influences and loyalties. The Advisers Act and related SEC rules provide a mature and comprehensive regulatory regime that covers virtually every aspect of our business and that subjects ISS to the SEC's continuing oversight and examination authority. We must and do comply with these rigorous federal legal requirements. Being regulated under the Advisers Act also aligns us with our investor clients, many of whom are themselves also registered and regulated under the Advisers Act.

In this context, I am confident you will find that the Advisers Act effectively addresses many of your concerns.

Our response to your letter is organized as a direct reply to each statement and question you've posed (italicized):

- *"For years, your organization has significantly increased it[s] influence in shareholder voting practices, and between Institutional Shareholder Services (ISS) and Glass, Lewis & Company (Glass Lewis), you now control 97 percent of the of the [sic] proxy advisory industry..."*

ISS is indeed an industry leader in the corporate governance space and we are proud to have earned our market share by virtue of the quality of our work and the level of service we have provided for more than a quarter century. The GAO report entitled "Issues Relating to Firms that Advise Institutional Investors on Proxy Voting" concluded as much when it wrote that ISS has "gained a reputation with institutional investors for providing reliable, comprehensive proxy research and

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recommendations."[1] While we have seen the widely circulated conjecture that two firms "control" 97% of the proxy advisory industry, this is not a statistic we have verified or can confirm.

There are no artificial barriers to entry into the proxy advisory industry in the United States. We operate in a competitive market and we have seen entrants come and go within the industry. Moreover, institutional investors are not required to purchase our services. In the free market, institutional investors purchase our services because they choose to do so, and find value in the products we provide.

We do, however, want to draw a distinction between our market leadership and your assertion that we influence "shareholder voting practices." ISS clients control both their voting policies and their vote decisions. ISS is generally not a discretionary proxy voting manager, except in rare situations where a client has an actual conflict of interest (for example, a financial institution that holds and must vote the shares of its parent company), and asks ISS to make a proxy voting decision on the client's behalf.

In fact, ISS is relied upon by our clients to assist them in fulfilling their own fiduciary responsibilities regarding proxy voting and to inform them as they make their proxy voting decisions. These clients understand that their duty to vote proxies in their clients' or beneficiaries' best interests cannot be waived or delegated to another party. Proxy advisors' research and vote recommendations are often just one source of information used in arriving at institutions' voting decisions. As participants in the SEC's 2013 Proxy Adviser Roundtable explained, many investors have internal research teams that conduct proprietary research and use proxy advisory research to supplement their own work.[2] Some investors use third-party proxy research as a screening tool to identify non-routine meetings or proposals. A number of institutional investors use the services of two or more proxy advisory firms. These views are consistent with the results of a 2012 survey of asset managers by Tapestry Networks that found proxy advisory firms' "role as data aggregators" has become increasingly important to asset managers, and that even if smaller managers are more reliant on such advisory firms, they still acknowledge that responsibility for voting outcomes lies with investors.[3] Said more simply, we are an independent provider of data, analytics and voting recommendations to support our clients in their own decision-making.

Moreover, in their paper, *The Power of Proxy Advisors: Myth or Reality?*,[4] University of Pennsylvania Law School Professor Jill Fisch, along with colleagues from New York University, analyzed the effect of proxy advisor recommendations on voting outcomes in uncontested director elections. The authors estimate that, after controlling for underlying company-specific factors that influence voting outcomes, far from being determinative of outcomes, an ISS recommendation appears to shift a very small percentage (6 to 10 percent) of shareholder votes, but that this influence may stem from ISS' role as information agent:

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[1] Jones, Y. D. (2007). *Issues Relating to Firms that Advise Institutional Investors on Proxy Voting.* (GAO-07-765). Washington, DC: Government Accountability Office (hereafter, "2007 GAO Report") at 13.

[2] Remarks of Michelle Edkins, currently Managing Director, Global Head of BlackRock Investment Stewardship, BlackRock, Inc. Transcript of Proxy Advisory Firms Roundtable ("Roundtable Transcript"), available at www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt (December 5, 2013) at 45; remarks of Anne Sheehan, Director of Corporate Governance, CalSTRS, *Id.* at 153-54; remarks of Lynn Turner, Managing Director, LitiNomics, Inc., discussing his experience at Colorado Public Employees' Retirement Association, *Id.* at 51-52.

[3] Bew, Robyn and Fields, Richard, Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers (June 2012) at 2. Available at SSRN: http://ssrn.com/abstract=2084231. ("Across the board, participants in our research said they value proxy firms' ability to collect, organize, and present vast amounts of data, and they believe smaller asset managers are more reliant on those services. Nonetheless, participants emphasized that responsibility for voting outcomes lies with investors").

[4] Choi, Stephen J., Fisch, Jill E. and Kahan, Marcel, The Power of Proxy Advisors: Myth or Reality? 59 Emory L. J. 869 (2010); University of Pennsylvania, Institute for Law & Economics Research Paper No. 10-24. Available at SSRN: http://ssrn.com/abstract=1694535.

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> *[W]e find evidence that ISS's power is partially due to the fact that ISS (to a greater extent than other advisors) bases its recommendations on factors that shareholders consider important. This fact and competition among proxy advisors place upper bounds on ISS's power. Institutional Shareholder Services cannot issue recommendations arbitrarily if it wants to retain its market position. Doing so would lead institutional investors to seek the services of other proxy advisory firms.* ***Thus, ISS is not so much a Pied Piper followed blindly by institutional investors as it is an information agent and guide, helping investors to identify voting decisions that are consistent with their existing preferences*** *(emphasis added).*[5]

Many large institutional investors have their own customized voting and corporate governance principles that proxy advisory firms use as the basis for making tailored, client-specific vote recommendations for that particular investor. What this means is that a client with their own unique view of how to assess and vote upon proxy voting matters will look to ISS for assistance in the administration of their own customized proxy voting policy as opposed to using one of ISS' policy frameworks. As of January 1, 2018, approximately 85% of ISS' top 100 clients used a custom proxy voting policy. To provide further context, we note that during calendar year 2017, approximately 69% of the ballots processed by ISS on behalf of clients globally were linked to clients' custom policies, representing approximately 87% of the total shares processed by ISS during this period.

Moreover, in addition to both customized policies and our ISS "benchmark" proxy voting guidelines, ISS provides options for our clients in the form of multiple thematic, specialty policy options for investors who require a particular philosophical approach to proxy voting and corporate governance, including a policy set for faith-based investors and two focusing on social and environmental investing priorities. Again, the choice of which policy to use belongs to the client, not ISS. In other words, ISS does not have a monolithic view on proxy voting issues nor do we dictate how investors themselves think about these issues. Indeed, ISS has presented opposing recommendations on the same ballot proposal to different clients based on the differing policies/approaches of those clients and the proxy voting policies that they themselves select. In short, ISS provides investors with research, data and vote recommendations that enable them to implement their own proxy voting and corporate governance philosophies.

ISS is sometimes mislabeled as an "activist" organization. While the foregoing demonstrates that we are not, in fact, a monolith to which that or any similar label could apply, we think it is worth noting that for calendar years 2015, 2016 and 2017, under our "benchmark" policy guidelines, ISS recommended votes in support of the management position over 90% of the time (91.3%, 92.2% and 91.3% in each year, respectively).

As noted by the Council of Institutional Investors (CII), a leading nonpartisan and nonprofit association of public, corporate and union employee benefit funds and state and local entities with combined assets exceeding $3.5 trillion:

> Proxy advisory firm influence is exaggerated by analyses that confuse correlation with causation. ISS and Glass Lewis tend to follow investors on governance policy, not lead them. In setting their policy frameworks, the two firms have a business interest to ensure they reflect investor (client) perspectives, in part through extensive consultative processes, and to consider empirical evidence. Their franchises are built on credibility with investors. As a result, advisors' views reflect those of many funds. Indeed, if there were a sharp divergence, we would expect to see advisors punished in the marketplace.[6]

At the end of the day, institutional investors are not required to use proxy advisors' services or to use only one proxy advisory company, nor are they required to follow the vote recommendations of any proxy advisor they choose to use. The

[5] *Id.* at 906.

[6] June 13, 2016 letter from the Council of Institutional Investors to Rep. Hensarling, Chair of House Committee on Financial Services and Rep. Waters, Ranking Member of House Committee on Financial Services at 2.

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ultimate voting decision for each resolution at a company meeting remains the responsibility of our clients, the owners of the corporation, as we believe it should be.

Question 1 - ISS' Voting System

> *"We request that you provide detailed information on how the Proxy Exchange voting service works and why you think your company is in compliance with SEC Staff Legal Bulletin 20, especially in circumstances where each client does not have to formally approve or submit the pre-populated electronic ballot that you are producing for each shareholder meeting."*

Exchange Act Rule 14a-1(l) defines a proxy "solicitation" to include the "furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."[7] The furnishing of a proxy pursuant to a security holder's unsolicited request is excluded from this definition.[8]

Both the SEC and its Staff have historically recognized the distinction between unsolicited and solicited proxy advice, applying the Exchange Act proxy rules to the former, but not the latter. For example, in a 1979 release, the SEC explained that, "As a general matter, unsolicited proxy voting advice would constitute a 'solicitation' subject to the proxy rules."[9] In making this observation, the SEC cited an earlier opinion of the SEC's General Counsel that addressed proxy advice in a broker-dealer context:

> In our view, a broker normally is not engaged in solicitation where he merely responds, whether orally or in writing, to an unsolicited request from a customer for advice as to how to vote. Since the broker is merely responding to his customer's request for advice in his capacity as adviser to the customer and not actively initiating the communication, it may be concluded that he is not engaged in 'soliciting.'[10]

Unfortunately, the longstanding regulatory distinction between unsolicited and solicited proxy voting advice has been blurred as a result of more recent Staff guidance. In addressing the interplay between proxy advisory services and the federal proxy rules, Staff Legal Bulletin ("SLB") 20 (issued in June 2014) paraphrased the SEC's 1979 release, but omitted the critical "unsolicited" qualifier, thereby erroneously suggesting that all proxy advice is a solicitation.[11]

ISS submits that a registered investment adviser who is contractually obligated to furnish vote recommendations based on client-selected guidelines is not providing "unsolicited" proxy voting advice, and thus is not engaged in a "solicitation" subject to the Exchange Act proxy rules.

ISS does not choose the ballots or agenda items on which we render advice. Rather, at a client's direction, we are asked by our clients to analyze and provide a voting recommendation for each agenda item related to every equity security held in our clients' portfolios. Furthermore, as a disinterested fiduciary, ISS has no financial stake in the outcome of a particular vote. We are agnostic as to whether clients support a proposal, reject the proposal or abstain from voting altogether. We are similarly indifferent to whether clients choose to follow an ISS vote recommendation or not. ISS' only job is to analyze proxy statements

[7] Rule 14a-1(1)(iii)

[8] Rule 14a-1(l)(2)(i).

[9] *Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally,* SEC Release No. 34-16104 (August 13, 1979), 44 Fed. Reg. 48938 (August 20, 1979) at note 25.

[10] *Broker-Dealer Participation in Proxy Solicitations,* SEC Release No. 34-7208 (January 7, 1964). This view was restated in a letter from Abigail Arms, Chief Counsel of the Division of Corporation Finance to Richard G. Ketchum, EVP, Legal, Regulatory & Market Policy of the NASD, Inc. dated May 19, 1992.

[11] SLB 20, Question 6.

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and provide informed research and vote recommendations based on the policies and guidelines the institutional investors have selected, and in many cases developed, themselves. Given the diversity of these policies and guidelines and as already noted above, ISS may issue different recommendations on a given issue, for example, recommending voting "AGAINST" on a particular item to clients using ISS' faith-based policy guidelines, and "FOR" on that same issue to clients using ISS' "benchmark" voting policy guidelines.

ISS' fiduciary proxy research and voting advice is simply not the kind of "over-the-transom" communication that the federal proxy rules are designed to address.

Wholly apart from the question of whether the provision of proxy advice can be considered a solicitation, SLB 20 explains that Exchange Act Rule 14a-2(b)(3) exempts a proxy solicitor who renders voting advice from the information and filing provisions of the proxy rules if the solicitor:

a. furnishes proxy voting advice in the ordinary course of business;

b. discloses to the recipient of the advice any significant relationship with the issuer or any of its affiliates, or a security holder proponent of the matter under advisement, and discloses any material interests the solicitor has in such matter;

c. receives no compensation for furnishing the advice from anyone other than recipients of the advice; and

d. does not furnish the voting advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election.[12]

Although ISS is confident that it is not a proxy solicitor within the meaning of Rule 14a-1(l), we have nonetheless taken steps to ensure that our proxy advisory activities would qualify for the Rule 14a-2(b)(3) exemption if such an exemption were needed. In this regard, after the publication of SLB 20, ISS enhanced our already robust suite of conflict management and disclosure policies by adopting a *Policy Regarding Disclosure of Significant Relationships*. This Policy, which is available in the Due Diligence section of our website,[13] provides a clear explanation of how ISS assesses and discloses any significant relationships that may exist between the company and the subjects of its proxy research reports.

ISS also enhanced its client facing delivery platform, ProxyExchange, to deliver the required disclosures to clients in a way that both seamlessly integrates with their workflows and protects the critical firewall between ISS and its corporate solutions subsidiary.

Question 2 - Report Accuracy

- *"Currently there are no standards or regulations that apply to these reports prepared by proxy advisory firms…[T]here are often questions about the dependability, accuracy of factual material, and correct assumptions made for each company evaluated."*

[12] SLB 20, Question 9. Questions 10 through 13 address how a proxy advisory firm that acts as a proxy solicitor could make the facts-and-circumstances determination of whether it had a significant relationship with an issuer or security holder proponent or a material interest in the matter under advisement, and how it should make any necessary disclosures related thereto.

[13] htpps://www.issgovernance.com/file/duediligence/significant-relationships-disclosure.pdf. The ISS website contains a range of disclosures that satisfy ISS' regulatory requirements under the Advisers Act and assist fiduciaries who use ISS' services to satisfy their own business and regulatory obligations.

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The first sentence quoted above is inaccurate. In 2010, the SEC confirmed that proxy advice is a form of investment advice subject to the Advisers Act and the rules and regulations thereunder. [14] Among other things, this means that

> as a fiduciary, the proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information.[15]

The SEC restated this view just last month in a proposed interpretive release on investment adviser standards of conduct. In addition to confirming that the obligation to provide advice that is in the best interest of clients applies not only to advice regarding potential investments, but to all advice provided to clients, the SEC also confirmed that an adviser has a duty to conduct a reasonable investigation "sufficient to not base its advice on materially inaccurate or incomplete information."[16]

As an RIA and a fiduciary, ISS has adopted a number of policies and procedures designed to ensure the integrity of our data collection and research process, upon which our reports are founded. We have robust systems and controls designed to ensure that research reports and vote recommendations include high-quality, relevant information, are accurate, correctly based on the relevant ISS or client custom policy and are reviewed by appropriate personnel prior to publication. ISS also commissions regular SSAE 16 audits, conducted by a third-party auditor to ensure compliance with our internal control processes, including our research process.

ISS is committed to having the most complete and accurate information upon which to base our research and recommendations to our clients. As described in more detail below, ISS' approach is to use and rely only upon publicly available information in the preparation of our proxy research reports and vote recommendations, the primary source of which is the public filings of the companies that we cover. Within the parameters of that approach, ISS regularly undertakes dialogue and interacts with company representatives, institutional shareholders, shareholder proponents and other relevant stakeholders, both during and outside of "proxy season" to (1) gain the greatest possible insight for our clients and (2) maintain the overall quality of the research by ensuring full information and deeper insight into key issues. ISS' dialogue with issuers is transparent and disclosed to clients.

With respect to factual errors, ISS' research team does, infrequently, identify or receive notice of material factual errors in research reports that have already been published to our clients. These errors include those relating to agenda changes, material data or research/policy application. ISS tracks such occurrences, which are rare. For example, in 2017, ISS covered over 6,400 meetings in the United States and the error rate was approximately 0.76% as measured by post-publication "Proxy Alerts" to clients notifying them of a material error within our benchmark proxy research that resulted in a change of a vote recommendation.

We reiterate the findings of the 2007 GAO Report which concluded that our clients trust us to provide "reliable, efficient services."[17] The GAO's follow-up report in 2016 addressed this further, stating "Both corporate issuers and institutional investors [the GAO] interviewed said that the data errors they found in the proxy reports were mostly minor..."[18]

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[14] Concept Release on the U.S. Proxy System, IA Release No. 3052 (July 14, 2010) ("Proxy Concept Release") at 110.

[15] *Id.*, at 119.

[16] Proposed SEC Interpretation Regarding Standard of Conduct for Investment Advisers, IA Release No. 4889 (April 18, 2018) ("IA Interpretive Release"), at 13, *quoting t*he Proxy Concept Release.

[17] 2007 GAO Report *supra*, note 1 at 13.

[18] Clements, M. (2016). *Proxy Advisory Firms' Role in Voting and Corporate Governance Practices.* (GAO-17-47). Washington, DC: Government Accountability Office at 29.

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However, we want to underscore that there is a fundamental and important difference between factual errors and disagreements over interpretive judgment and methodology. Although the latter are often referred to as "errors," they do not entail any mistake, omission or misrepresentation. What is often portrayed as an "error" by the management and/or the board of a company may be a disagreement about the vote recommendation itself or about the underlying corporate governance guidelines applied.[19] For example, ISS was recently accused by a company of selecting inappropriate company peers for the purpose of manipulating the assessment of the issuer's executive compensation program in the context of a "say-on-pay" agenda item. However, ISS had, as always, followed its consistent and publicly-disclosed methodology for ISS peer group determinations and had also, in fact, already considered new information provided by the issuer and adjusted our initial determination to remove one peer and add a different one in line with the company's representations. In presenting the information to our clients in our report and consistent with our normal approach, we outlined in side-by-side fashion the peers selected by the issuer and the ISS-selected peers. In this particular case, there was overlap of 12 of the 16 peer companies and the variance was not an error but rather reflected ISS' thoughtful and independent assessment of the matter, precisely what our clients expect of us.

We acknowledge that policy differences on important issues such as executive compensation, overboarding (i.e. how many boards an individual can serve on effectively), and whether the CEO and Chairman of the Board should be different individuals, can sometimes generate tension between shareholders (and by extension ISS) and the companies in which they invest. However, it is the policies selected by our clients that dictate our vote recommendations and the application of those policies does not equate to our work product being erroneous or manipulative.

➢ *"We understand that your company and other proxy advisory firms hire more staff to meet the demands of proxy season by hiring temporary workers and outsourcing a significant amount of research and analytical work."*

To help meet our clients' needs during proxy season, ISS does indeed hire "temporary" employees. Temporary employees are subject to the same employment onboarding procedures that apply to "permanent" hires, including training regarding ISS' compliance program and subject matter training with respect to the tasks and issues that will fall within an employee's work responsibilities. Temporary employees do not undertake work beyond their training and experience and these employees are generally focused on data collection and capture. It is also not uncommon for some "temporary" employees to return to ISS on a recurring basis.

ISS does not outsource any of its research and analytical work.

➢ *"Why hasn't ISS expanded [its] draft review process to include more companies, in order to improve the quality of the reports for issuers not listed in the S&P 500 index? Are you willing to expand the draft review process to companies listed in the S&P 1500, [sic] with a reasonable transition period?"*

As you note, the shareholder proxy season is "short." The condensed schedule affects the process that advisors like ISS employ in producing proxy reports and formulating vote recommendations. ISS has incorporated a limited issuer review step for S&P 500 companies because these companies are the most widely held by our clients and generally have the most complex disclosures. ISS voluntarily provides most companies in this index the opportunity to review the factual accuracy of the data included in ISS' pending proxy analyses. Because we are committed to the accuracy and quality of our reports, we consider other requests for review on a case-by-case basis.

However, given the limited time between the hard start of receiving the proxy statement and the hard stop of delivering the report to our clients with sufficient review time in advance of their having to make their voting decisions, expanding the included coverage universe would require a significant increase in resources and a concurrent increase to our clients of the costs of our services (which, of course, is ultimately borne by the underlying beneficial shareowners). Moreover, even if

[19] As Anne Sheehan of CalSTERS observed at the SEC's Proxy Adviser Roundtable, "What I have found [is] that many times the errors are really differences of opinion." Roundtable Transcript, *supra*, note 2, at 155.

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additional resources were added, the time constraints remain substantial -- we remain concerned about the value and feasibility of accommodating an expanded draft review process and still being able to meet the imperative of providing our clients with our research on a timely basis. ISS does, however, work continually to enhance the quality of all of our product/service offerings, and is open to appropriate changes that are sensible, commercially viable and which would provide additional value to our clients and other stakeholders. Expansion of the coverage universe of our current draft review process is one potential change that ISS has considered and will continue to do so.

All issuers, even if they do not receive a draft report for review, are entitled to receive a free copy of ISS' published analysis for their own shareholder meeting. This affords all issuers the opportunity to bring any factual error in the report to ISS' attention and as noted elsewhere in this response, we have a formal process to update previously issued reports where necessary and communicate those updates to our clients.

- *"Do you have specific policies and procedures regarding providing draft report to issuers? If so, please include a copy of those policies and procedures."*

Yes. ISS' approach to the provision of draft reports to issuers (which is available on our website), is as follows:

> There is no entitlement to review our research reports prior to publication to our clients, but draft reports are provided in certain markets as a courtesy and at the sole discretion of ISS, in order to allow an issuer to check the factual information prior to publication. For example, in the United States, companies in the S&P 500 index will generally receive a draft report for fact-checking if they have provided contact details, and for France, the process is set out in our Engagement and Draft Report Disclosure Policy for the French Market.
>
> To ensure consideration can be given to any review responses within the often tight publication deadlines for our reports, any comments should be sent back to ISS by e-mail, although companies are welcome to provide a hard copy as well. Note that this is not an opportunity for the issuer to lobby for a particular voting recommendation, but to check the facts that are being included in our report. Procedures for providing draft reports to companies vary on a market-by-market basis, and in any case, no drafts will be provided in markets or situations where there is insufficient time to do so whilst still respecting our clients' voting deadlines.
>
> For all markets, ISS does not normally allow pre-publication reviews of any analysis relating to any special meeting or any meeting where the agenda includes a merger or acquisition proposal, proxy fight, or any item that ISS, in its sole discretion, considers to be of a contentious or controversial nature. This policy is intended to safeguard the independence of our process and recommendations.

- *"When do you provide issuers draft reports and how much times do they have to provide their comments on factual issues?"*

Draft reports are generally emailed to company contacts in the two-to-four week period before an issuer's annual meeting. During the height of proxy season, the time frame may be closer to two to three weeks before the meeting. We will generally advise the company contacts beforehand when to expect the draft report for review, and the cover letter accompanying the draft report specifies the deadline for the issuer's comments, which typically provides the company with 2 business days to provide comments.

- *"If an issuer identifies an error in a draft report what corrective measure do you take?"*

If an issuer identifies an error in a draft report, the matter is reviewed by the relevant research analysts and any identified and agreed errors are corrected prior to the finalization of the report and its delivery to our clients.

With respect to final reports that have already been published, if a material error is identified (whether by ISS, the issuer or an investor), or updated relevant information is publicly released by the issuer (for example, through supplemental proxy

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material filed with the SEC), ISS promptly issues an aforementioned "Proxy Alert" to inform clients of any corrections, new information available and, if necessary, any changes in the vote recommendations as result of those corrections or updates. Alerts are distributed to ISS' clients through the same ProxyExchange platform used to distribute the regular proxy analyses. This ensures that the clients who received an original analysis and recommendations will also receive the related Alert.

➢ *"Do you publicly disclose your guidelines and methodologies for preparing draft reports? If not, why not?"*

Yes. All proprietary proxy analysis at ISS is undertaken in accordance with the publicly disclosed analytical framework which is comprised of the full voting policy guidelines for all policies offered by ISS. The only exception to this is for the client-specific customized policies which are each client's own proprietary information. As described above, ISS offers a wide range of proxy voting policy options, providing to our clients both a benchmark policy focused on good governance principles, shareholder protection and mitigation of governance risk, and a wide array of specialty policies that evaluate governance and other voting issues from the perspective of sustainability, socially responsible investing, public pension funds, labor unions or mission and faith-based investing. To ensure the ISS proprietary voting policies take into consideration the changing views and needs of its institutional investor clients and the perspectives of companies and the broader corporate governance community, ISS gathers input each year from institutional investors, companies, and other market constituents worldwide through a variety of channels and over many months.

Case-by-case analytical frameworks, which take into account company size, financial performance and industry practices, also drive many of ISS' vote recommendations on more complex issues, such as those pertaining to the election of corporate directors, compensation matters, and capital or shareholder rights-related proposals.

All ISS Policy Guidelines for 2018, covering the U.S., all global markets and ISS' specialty policies can be found in the "Policy Gateway" section of our website (https://www.issgovernance.com/policy-gateway/voting-policies/).

Question 3 - Conflicts of Interest

An obligation to either eliminate, or manage and disclose, conflicts of interest is the very essence of an investment adviser's fiduciary duty of loyalty. The SEC most recently confirmed this fact in its proposed interpretive release on investment adviser standards of conduct, saying:

> In seeking to meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship. In addition, an adviser must seek to avoid conflicts of interest with its clients, and at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship. The disclosure should be sufficiently specific so that a client is able to decide whether to provide informed consent to the conflict of interest . . . . Because an adviser must serve the best interests of its clients, it has an obligation not to subordinate its clients' interests to its own . . . Accordingly, the duty of loyalty includes a duty not to treat some clients favorably at the expense of other clients.[20]

Advisers Act Rule 206(4)-6 applies this traditional fiduciary concept to proxy voting by requiring an RIA who has expressly or implicitly assumed voting authority over its clients' portfolios to adopt written policies and procedures reasonably designed to ensure that the adviser monitors corporate actions and votes proxies in the clients' best interests; supplies those policies and procedures to clients upon request; and offers clients information about specific votes cast on their behalf.

As an RIA, ISS takes this fiduciary duty of loyalty very seriously. ISS places primary importance on conducting our business in a transparent and responsible manner, and has developed a comprehensive program to manage potential conflicts of interest as required by the Advisers Act and related SEC rules. In this regard, ISS has undertaken a comprehensive risk assessment to identify specific conflicts of interest related to its operations and has adopted

[20] IA Interpretive Release,, *supra* note 15, at 15-16 (citations omitted).

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compliance controls reasonably designed to manage those risks. Moreover and as discussed above, ISS has adopted a significant relationship disclosure policy and took robust steps to enhance transparency following the promulgation of SLB 20. At the heart of ISS' regulatory compliance program is a deliberate, carefully crafted, regularly tested and periodically updated series of measures designed to eliminate, or manage and disclose conflicts of interest.

Separate and apart from our compliance protocols, ISS addresses conflicts, in part, by being a transparent, policy-based organization, with research and voting recommendations based on publicly-disclosed information available to all shareholders. We provide our clients with an extensive array of information to ensure that they are fully informed of our policies to manage conflicts of interests, and of any potential conflicts and the steps ISS has taken to address them. Among other things, ISS supplies a comprehensive due diligence compliance package, also publicly available on our website, so that our clients can confidently and fully assess the reliability and objectivity of our voting recommendations.

➢ *"Your company has established a consulting service that charges public companies a fee to learn how to best to comply with ISS benchmark voting policies and obtain favorable recommendations in the future."*

To be clear, ISS Corporate Solutions, Inc. ("ICS"), a wholly-owned subsidiary of ISS, provides governance data, analytics and services to corporate issuer clients. ICS' stated mission is help companies design and manage their corporate governance and executive compensation programs to align with company goals, reduce risk, and manage the needs of a diverse shareholder base by delivering best-in-class data, tools, and advisory services. ICS does not and cannot provide any client with any assurance as to how ISS will recommend with respect to the matters that appear on any client's proxy statement.

➢ *"What types of conflicts do you disclose and how accessible are these disclosure[s] to your clients when voting decisions are being made?"*

As required by the Advisers Act's compliance program rule,[21] ISS has implemented, maintains and periodically updates a program designed to eliminate, or manage and disclose, conflicts of interest. In addition to appointing a chief compliance officer, establishing comprehensive compliance policies and procedures, and testing the adequacy of those policies and procedures and the effectiveness of their implementation on an ongoing basis, ISS has also adopted a comprehensive Code of Ethics as the Advisers Act regulatory regime also requires.[22] ISS' Regulatory Code of Ethics is available on our public website at https://www.issgovernance.com/file/duediligence/iss-regulatory-code-and-exhibits-june-2017.pdf. In addition to mandating disclosure regarding an RIA's Code of Ethics, the Advisers Act and related rules also dictate that we provide clients with transparency about our internal operations, including how potential conflicts of interest are addressed.

In conformance with our regulatory obligations, ISS has identified the following potential conflicts:

- Conflicts between ISS' institutional global research department and ICS
- Conflicts within the institutional advisory business
- Conflicts arising from an analyst's stock ownership
- Conflicts in connection with issuers' review of draft analyses
- Conflicts in connection with ISS' ownership structure

Conflict disclosure is addressed first and foremost in the Form ADV disclosure brochure that we must deliver to all clients at the outset of the relationship and must update periodically thereafter.[23] In addition to delivering this brochure to clients, ISS also includes the most recent version of the brochure in the due diligence compliance package available to the public

[21] *See* Advisers Act Rule 206(4)-7.

[22] *See*. Advisers Act Rule 204A-1.

[23] *See*. Advisers Act Rule 204-3.

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on the ISS website. ISS clients can also readily identify any potential conflict of interest through ISS' primary client delivery platform, ProxyExchange, which provides information about the identity of ICS clients, as well as the types of services provided to those issuers and the revenue received from them. Similarly, each proxy analysis and research report issued by ISS contains a legend indicating that the subject of the analysis or report may be a client of ICS. This legend also advises institutional clients about the way in which they can receive additional, specific details about any issuer's use of products and services from ICS, which can be as simple as emailing our Legal/Compliance department.

- *"Are you willing to disclose potential and actual conflicts on the front page of company reports, as Glass Lewis does?"*

Although in our experience investment advisers typically disclose conflict-of-interest information at a macro level, ISS does more. Any institutional client that wishes to learn more about the relationship, if any, between ICS and the subject of a particular analysis or report may access this information through ProxyExchange and/or through contacting ISS' Legal/Compliance department for relevant details. This process allows ISS' proxy voting clients to receive the names of ICS clients without revealing that information to research analysts as they prepare vote recommendations and other research. Identifying an ICS relationship on the face of a proxy analysis or report would destroy the conflict-of-interest firewalls we have created in this area. While it would actually be easier for us to provide this disclosure on the report itself, we believe that eliminating such a critical conflict control would not be in our clients' best interest.

- *"Do your disclosures include, in monetary terms, the size of the client relationship involved and do you disclose conflicts involv[ing] more than one proponent or active supporter of a particular shareholder proposal?"*

Yes, ISS makes available to its institutional clients the identity of all ICS clients, the particular products/services they receive, and the fees paid to ICS. Again, this information can be readily accessed via the ProxyExchange platform or by emailing ISS' Legal/Compliance department. In addition to obtaining report-by-report conflict information, ISS clients can obtain lists of all ICS clients. Further, many clients meet with ISS staff on an annual basis to discuss conflicts and other due diligence matters.

Beyond the disclosure approach regarding the ICS clients, the *Policy Regarding Disclosure of Significant Relationships* referred to above explains ISS' approach for disclosing other types of potential conflicts, including those that might arise with respect to a proponent or active supporter of a particular shareholder resolution.

- *"Does ISS allow hedge fund clients to purchase Special Situations Research or other services at the same time that ISS is recommending for or against a pending merger, buyout, or proxy fight in which the hedge fund has an interest?"*

Yes.

- *"Please provide a record of each instance of proxy voting advice that your company or any regulatory body has determined constituted or may have constituted a conflict of interest over the last 10 years, and all related documents and communication. If no such record is maintained, please explain why."*

ISS is not aware of any instance in which a proxy research report or a vote recommendation was compromised by a conflict of interest, nor any instance where a regulatory body has reached that conclusion. As discussed at length above, ISS has worked hard to identify potential conflicts of interest and taken concrete steps to manage and mitigate those potential conflicts so that they do not impact the efficacy or integrity of our research and recommendations. We are heartened by the fact that the most vocal critics of ISS on this point are those who speak on behalf of corporate management, and not the investors who rely on ISS' research and vote recommendations. We see this as a strong indication that we are managing this potential conflict extremely well.

- *"Please provide a list of all outside entities from whom you obtain information referring or relating to your proxy voting advice, and descriptions of any evaluations that are performed to ensure such information is accurate and that*

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the information provider does not have a conflict of interest with the company with respect to which the information is being provided."

As explained above, ISS' approach is to use and rely only upon publicly available information in the preparation of our proxy research reports and vote recommendations. The primary source of that information is the public filings of the companies that we cover, meaning, for U.S. companies, the proxy statement and other reporting materials that companies are required to file with the SEC, supplemented by press releases, information from a company's website and other generally accessible information. ISS also uses a small number of third-party vendors to provide standardized financial information and securities identifiers. ISS submits that this approach fully complies with our fiduciary duty of care described above.

- *"We are interested in whether you disclose two other types of conflict of interest. The first of these two conflicts involves cross-ownership, where owners or executives of your firm may have a significant ownership interest in, or serve on the board of directors of entities that have proposals on which the firm is offering vote recommendations. The second conflict involves other financial interests by your owner, Genstar Capital."*
- *"Are you disclosing these financial or business relationships when they involve or include a proponent or an active supporter of matters in which you are making voting recommendations?"*

ISS' executives, like all of our employees, are required to disclose to ISS and ISS will, in turn, disclose to our clients any significant (or material) ownership interest that an executive might have with regard to a company on which we are providing proxy research coverage.[24] ISS' executives are not permitted to sit on the Board of Directors of a public company except in extremely limited circumstances and only with the approval of ISS' General Counsel and the company's senior management. No such exceptions are currently in effect and so no ISS employee currently serves as a director of a public company.

ISS is a privately-held company, whose ultimate owner is affiliated with Genstar Capital, a private equity firm. ISS has adopted a Policy on Potential Conflicts of Interest Related to Genstar Capital and its affiliated funds (the "Genstar Policy"). Among other things, the Genstar Policy provides that Genstar persons (defined as Genstar directors and certain others) may not participate in the formulation, development and application of ISS voting policies, and will not have access to any data relating to the portfolio, investment strategy or securities holdings of ISS clients. In addition, as a private equity firm that owns or controls a number of operating companies, some of which may become publicly traded, and may thereafter be the subject to ISS research, we recognize that actual or potential conflicts of interest, or the appearance of conflicts, could arise in the production by ISS of research with respect to coverage of such a Genstar company (what we refer to as a "Genstar Affiliated Company"). ISS therefore provides disclosure of these relationships on its website, and includes information about any such relationship in the research report for any issuer that happens to be a Genstar Affiliated Company. Currently, there are no Genstar Affiliated Companies.

Pertinent Legislation before the Senate Banking Committee

Finally, we want to reiterate our strong view that both of the pertinent legislative proposals before the Senate Banking Committee – H.R. 4015, "The Corporate Governance Reform and Transparency Act," and Subtitle Q of Title IV under H.R.10, "The Financial CHOICE Act" (FCA) – are misguided attempts to improve corporate governance. Each of these proposals would only deepen your concerns about industry competition and conflicts of interest. Each proposal would eliminate a proxy adviser's existing fiduciary duties of care and loyalty to investors, the owners of the companies in which they invest, and would infuse a proxy adviser's operations with a new issuer-related conflict of interest that would be

[24] Note that the ISS Regulatory Code of Ethics requires all employees to provide the ISS compliance department with account statements for all securities investment accounts for the employees and members of their immediate families. Certain types of trades must be pre-cleared and ISS imposes black-out periods on trading of issuers whose proxies are currently being analyzed or acted upon by the company. This black-out period extends from the time ISS logs receipt of the subject proxy into the Global Research database of meetings, until one day after the shareholders' meeting being covered.

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difficult to manage effectively. In this way, either bill, if enacted, would harm every shareholder who relies on independent research to make informed investment decisions.

Shareholders should have the right to choose the tools, services and information they need to make informed proxy voting decisions– without it being filtered through the management of the corporation in question. This is a fundamental tenet of corporate governance and it is why this bill is opposed by a number of large public sector pension fund managers, as well as many other institutional investors, including the CII, NCPERS, AFL-CIO, AFSCME and Teamsters to name a few.

The proposed new regulatory regime under both bills will do nothing to enhance competition in the industry. Indeed, it may actually erect barriers to entry and make it more difficult for smaller industry participants to compete. The proposed regulatory regime is unnecessary, burdensome and would do nothing to enhance market competition or create market conditions conducive to new proxy advisors entering the market. CII wrote in its most recent opposition letter that the proposed regulatory regime would "**increase barriers** [emphasis supplied] to new entrants and potentially lead some current proxy advisory firms to exit the industry altogether."[25]

The National Conference on Public Employee Retirement Systems (NCPERS), the largest national, nonprofit public pension advocate whose members manage more than $3 trillion in pension assets, warned that the suggested regime proposes to "bypass free-market principles by authorizing the SEC to pre-qualify industry entrants based on a set of vague and highly subjective standards."[26] Such authority would likely provide the SEC – under this and future Administrations – with broad discretion to establish criteria to further restrict, not enhance, competition.

The litmus test for any federal intrusion into the free market is whether it targets a proven problem and seeks to address it cost-effectively. The proposed bill does not pass either test. As the foregoing discussion demonstrates, the investors who use proxy advisory services do not see the "problem" the proposed legislation purports to address. Furthermore, the bill's backers fail to provide any cost-benefit analysis to support the idea of supplanting a comprehensive and mature regulatory regime with a brand new scheme that will require several years of new SEC rulemaking only to end up with something that favors entrenched corporate interests over shareholders, freedom of choice, freedom of expression and free-market capitalism.

In conclusion, ISS appreciates the opportunity to answer your questions and underscore the rigorous regulatory system and internal compliance program under which we operate. If there is any additional information I can provide, please do not hesitate to contact me.

Sincerely,

Gary Retelny, President and CEO
Institutional Shareholder Services Inc.

[25] Letter from the CII to Sen. Michael Crapo, Chair of the Senate Committee on Banking, Housing and Urban Affairs and Sen. Sherrod Brown, Ranking Member of the Senate Committee on Banking, Housing and Urban Affairs (February 28, 2018) at 2.

[26] Letter from NCPERS to Sen. Michael Crapo, Chair of the Senate Committee on Banking, Housing and Urban Affairs and Sen. Sherrod Brown, Ranking Member of the Senate Committee on Banking, Housing and Urban Affairs (February 16, 2018) at 2.

Press Release

SEC Expands the Scope of Smaller Public Companies that Qualify for Scaled Disclosures

FOR IMMEDIATE RELEASE
2018-116

Washington D.C., June 28, 2018 — The Securities and Exchange Commission today voted to adopt amendments to the "smaller reporting company" (SRC) definition to expand the number of companies that qualify for certain existing scaled disclosure accommodations.

"I want our public capital markets to be a place where smaller companies can thrive and thereby provide our Main Street investors with more access to investing options where our public company disclosure rules and protections apply," said SEC Chairman Jay Clayton. "Expanding the smaller reporting company definition recognizes that a one size regulatory structure for public companies does not fit all. These amendments to the existing SRC compliance structure bring that structure more in line with the size and scope of smaller companies while maintaining our long-standing approach to investor protection in our public capital markets. Both smaller companies — where the option to join our public markets will be more attractive — and Main Street investors — who will have more investment options — should benefit."

The new smaller reporting company definition enables a company with less than $250 million of public float to provide scaled disclosures, as compared to the $75 million threshold under the prior definition. The final rules also expand the definition to include companies with less than $100 million in annual revenues if they also have either no public float or a public float that is less than $700 million. This reflects a change from the revenue test in the prior definition, which allowed companies to provide scaled disclosure only if they had no public float and less than $50 million in annual revenues. The rules will become effective 60 days after publication in the Federal Register.

The amendments do not change the threshold in the "accelerated filer" definition that requires, among other things, that filers provide the auditor's attestation of management's assessment of internal control over financial reporting. However, Chairman Clayton has directed the staff, and the staff has begun, to formulate recommendations to the Commission for possible additional changes to the "accelerated filer" definition to reduce the number of companies that qualify as accelerated filers in order to further reduce compliance costs for those companies.

FACT SHEET
Amendments to the
Smaller Reporting Company Definition
SEC Open Meeting
June 28, 2018

Background

Today the Commission approved amendments to raise the thresholds in the smaller reporting company definition, thereby expanding the number of smaller companies eligible to comply with our current scaled disclosure requirements. These amendments are intended to promote capital formation and reduce compliance costs for smaller companies while maintaining appropriate investor protections.

The Commission established the smaller reporting company ("SRC") category of companies in 2008 in an effort to provide general regulatory relief for smaller companies. SRCs may provide scaled disclosures under Regulation S-K and Regulation S-X. Under the previous definition, SRCs generally were companies with less than $75 million in public float. Companies with no public float – because they have no public equity outstanding or no market price for their public equity – were considered SRCs if they had less than $50 million in annual revenues.

Amendments to the Smaller Reporting Company Definition

Under the amendments, companies with a public float of less than $250 million will qualify as SRCs. A company with no public float or with a public float of less than $700 million will qualify as a SRC if it had annual revenues of less than $100 million during its most recently completed fiscal year.

The following table summarizes the amendments to the SRC definition.

Criteria	Previous SRC Definition	Revised SRC Definition
Public Float	Public float of less than $75 million	Public float of less than $250 million
Revenues	Less than $50 million of annual revenues and no public float	Less than $100 million of annual revenues and • no public float, or • public float of less than $700 million

Consistent with the previous definition, under the amendments, a company that determines that it does not qualify as a SRC under the above thresholds will remain unqualified until it determines that it meets one or more lower qualification thresholds. The subsequent qualification thresholds, set forth in the table below, are set at 80% of the initial qualification thresholds.

Criteria	Previous SRC Definition
Revised SRC Definition	

Criteria	Previous SRC Definition	Revised SRC Definition
Public Float	Public float of less than $50 million	Public float of less than $200 million, if it previously had $250 million or more of public float
Revenues	Less than $40 million of annual revenues and no public float	Less than $80 million of annual revenues, if it previously had $100 million or more of annual revenues; and Less than $560 million of public float, if it previously had $700 million or more of public float.

Commission staff estimates that 966 additional companies will be eligible for SRC status in the first year under the new definition. These include: 779 companies with a public float of $75 million or more and less than $250 million; 161 companies with a public float of $250 million or more and less than $700 million and revenues of less than $100 million; and 26 companies with no public float and revenues of $50 million or more and less than $100 million.

Amendments to Rule 3-05 of Regulation S-X

The amendments to Rule 3-05(b)(2)(iv) of Regulation S-X increase the net revenue threshold in that rule from $50 million to $100 million. As a result, companies may omit financial statements of businesses acquired or to be acquired for the earliest of the three fiscal years otherwise required by Rule 3-05 if the net revenues of that business are less than $100 million.

Amendments to the Accelerated Filer and Large Accelerated Filer Definitions

The final amendments preserve the application of the current thresholds contained in the "accelerated filer" and "large accelerated filer" definitions in Exchange Act Rule 12b-2. As a result, companies with $75 million or more of public float that qualify as SRCs will remain subject to the requirements that apply to accelerated filers, including the timing of the filing of periodic reports and the requirement that accelerated filers provide the auditor's attestation of management's assessment of internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002. However, the Chairman has directed the staff, and the staff has begun, to formulate recommendations to the Commission for possible additional changes to the "accelerated filer" definition that, if adopted, would have the effect of reducing the number of companies that qualify as accelerated filers in order to promote capital formation by reducing compliance costs for those companies, while maintaining appropriate investor protections.

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Related Materials

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

October 5, 2017

The Honorable Carolyn Maloney
Ranking Member
Subcommittee on Capital Markets, Securities, and Investment
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Ranking Member Maloney:

Thank you for your letter dated September 14, 2017 concerning the market effects to the regulation of money market funds ("MMFs") that the Commission adopted in 2014 and which were fully implemented in October of last year. I appreciate your interest in this issue and share your goal of preserving liquidity in the short-term funding markets and minimizing disruptions to investors, markets, and market participants.

The Commission, in the 2014 release adopting the reforms, indicated that the impetus behind the reforms was a concern that MMFs, as they existed then, could pose risks to investors and the broader markets, particularly to the extent their features may have created a first-mover advantage that incentivized investor runs during periods of market stress. The Commission's adopting release further noted the harm that can result from rapid investor redemptions during periods of market stress, as the Reserve Fund's Primary Fund "broke the buck" and other prime institutional funds experienced heavy redemptions — which in turn caused fund managers to retain cash, thereby freezing short-term financing markets. Ultimately, as the 2014 release describes, the Department of the Treasury intervened with its Temporary Guarantee Program — extraordinary measures that helped quiet the market disruptions. Treasury was subsequently prohibited by statute from undertaking such measures in the future, thereby creating the need for structural reforms to the markets to prevent such disruptions going forward.

Accordingly, the 2014 reforms included certain structural reforms designed to mitigate run risk in MMFs. These included a floating NAV for all institutional prime (e.g., non-government and retail) MMFs designed to address potential first-mover advantages. The reforms also provide non-government MMF boards new tools — liquidity fees and redemption gates — which are designed to help MMFs better manage any potential investor run should one occur.

The staff have been closely monitoring the implementation of the 2014 reforms and reviewing their impact on MMFs and the short-term funding markets. Based on their review and analysis, the staff have shared the following observations.

- As MMFs were implementing the 2014 reforms, there was a shift in assets of approximately $1.1 trillion from prime MMFs into government MMFs. Despite this reallocation, overall MMF assets remained largely stable (at about $3 trillion) throughout this period and to date.

- During this period, some short-term rates increased, though these rate increases have since dissipated. The reallocation of assets from prime to government MMFs and potential effects on yields in the short-run were possible consequences of the reforms that were anticipated and discussed in the rule's 2014 adopting release. At that time, the Commission determined, however, that realizing the goals of the rulemaking justified the reforms, despite the potential costs.

- Since the October 2016 compliance date for the reforms, investor fund reallocations have not significantly changed, with assets in both government and prime MMFs largely stabilizing. The time period since the compliance date of the reforms has also coincided with a rising interest rate environment, with the Federal Reserve raising short-term interest rates several times over the last year. This has resulted in yield increases for MMFs.

The staff have further informed me that, as the reforms went into effect, many fund managers chose to realign their fund offerings and close certain funds, many of whose assets had been shrinking during the extended low interest rate environment. These changes have led to some reductions in investment in prime and municipal MMFs, particularly when combined with the reallocation of assets from prime to government funds that I mentioned above. To the extent that MMFs experiencing outflows invested more heavily in certain types of assets than the MMFs receiving inflows during this period, those types of assets could be experiencing decreased demand from MMFs. Some market participants and corporate and municipal issuers suggest that this decrease in demand for commercial paper and short-term municipal securities from MMFs and related increase in demand for government securities from MMFs is one of the primary impacts of the 2014 reforms on the short-term funding market.

I appreciate your question regarding the SEC potentially reversing the floating NAV element of the 2014 reforms. It is difficult at this time, however, to predict what the impact on prime and municipal funds would be if the Commission were to permit them again to use a stable $1.00 NAV. While some investors might choose to leave government MMFs and return to prime and municipal funds, such a shift also might not occur if investors newly appreciate prime and municipal MMFs' inherent liquidity and principal stability risks and therefore choose to remain in government MMFs. The MMF reforms were not fully implemented until October 2016, and I am concerned that making major changes at this time could be disruptive to the short-term funding markets. The Commission and its staff are monitoring the short-term funding markets and MMFs' activities generally, and will remain focused on the role MMFs play for investors and the short-term markets.

Thank you again for your letter and for your attention to this important matter in our capital markets. Should you wish to discuss these issues further, please do not hesitate to contact

The Honorable Carolyn Maloney
Page 3

me at (202) 551-2100 or have your staff contact Bryan Wood, Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2010.

Sincerely,

Jay Clayton
Chairman

The New York Times

FAIR GAME

Sarbanes-Oxley, Bemoaned as a Burden, Is an Investor's Ally

By Gretchen Morgenson

Sept. 8, 2017

Seismic accounting scandals like the ones that sank Enron and WorldCom in the early 2000s have, happily, been scarce in recent years. But they may well resurface if elements of the Sarbanes-Oxley Act, the law created to curtail accounting fraud, are rolled back as some corporate executives are urging.

Tom Farley, president of the NYSE Group, which operates the New York Stock Exchange, is among those leading the charge. In congressional testimony in July, he criticized the law's provision requiring auditors of publicly held companies to report on and attest to management's assessment of internal controls on financial reporting. The requirement is costly and burdensome to companies, Mr. Farley said, and helps to explain why the number of public corporations in the United States is declining.

He urged lawmakers to review the requirement because markets had evolved since it became law.

Mr. Farley's comments notwithstanding, it seems smart to have an outside auditor check on management's oversight of financial reporting. If a company does not have solid controls in place, how can investors trust its financial reports?

But investors do not seem to be a concern for Mr. Farley, who was speaking about the law (known as SOX) as an advocate for the big companies that list their shares on the New York Stock Exchange. "Designing, implementing and maintaining complex systems required to satisfy SOX's internal controls over financial reporting requirements can command millions of dollars in outside consultant, legal and auditing fees, in addition to other internal costs," he said.

Through a spokesman, Mr. Farley declined my request to expand on his views in an interview.

Since 1977, companies have been required by law to have effective internal controls over their financial reporting. But many failed to comply, as the subsequent accounting frauds and numerous financial restatements showed. That is why Congress decided in 2002, as part of Sarbanes-Oxley, to make auditors attest to corporate controls on financial reporting.

Lynn E. Turner, a former chief accountant of the Securities and Exchange Commission and a trustee of the Colorado Public Employees' Retirement Association, said he knew well that many companies hate having auditors assess their internal controls. But the regulation has done a lot to prevent devastating accounting frauds, he said.

"Corporate frauds like Enron, WorldCom and Tyco cost investors hundreds of billions of dollars and the NYSE and Nasdaq trillions of dollars in lost market capitalization," Mr. Turner said. "And they were a worldwide embarrassment to the United States."

Critics of the provision on financial reporting contend that it has not prevented accounting fraud, but a new academic study shows otherwise.

The analysis concludes that the external auditor requirement on corporate financial reporting is a highly effective warning system for corporate fraud. The study was recently published in Auditing: A Journal of Practice & Theory, a journal from the American Accounting Association.

Its authors are Matthew S. Ege, an assistant professor of accounting of Texas A&M University, and Dain C. Donelson and John M. McInnis, both of the University of Texas at Austin. They say their work is the first to link weak internal controls on financial reporting with a higher risk of undisclosed accounting fraud at public companies. And proof of this link is an important consideration when weighing the costs and benefits of Sarbanes-Oxley.

The academics collected auditors' opinions on internal controls at companies with more than $75 million in publicly held stock — about 3,500 companies per year — from 2004 through 2007. They searched for those with material weaknesses. Then they compared their findings with reports of financial fraud in S.E.C. and Justice Department enforcement actions from 2005 through 2010 as well as settled securities class-action lawsuits during the period.

The exercise identified roughly 1,500 reports of material weakness at companies. And within three years, 127 of those companies faced legal actions that revealed fraud, the study said.

That's not a big number. But here's where the study gets compelling. Auditors had identified material weaknesses in financial reporting at about 30 percent of the companies that later disclosed accounting problems. Chief executives were named in 111 of the 127 fraud cases, and chief financial officers were identified in 108 of the cases.

"Over all, we believe this link should be of interest to regulators and the general public," Mr. Ege said in an interview. "We need to ensure that entity-level weaknesses are being reported and not withheld."

Here's another reason to keep the financial reporting audit requirement: Research indicates that companies with weak financial reporting controls significantly underperform those with stronger setups. A 2007 study by Glass, Lewis & Company, for example, found that companies disclosing material weaknesses in their financial reporting during each of the prior three years were conspicuous market laggards.

Although critics of Sarbanes-Oxley prefer to focus on its vexing costs, an analysis in May by Ernst & Young, a big accounting firm, highlighted the law's benefits. They include a "decreased severity of financial restatements and increased investor confidence," the firm said.

Arguments like those raised by Mr. Farley of the NYSE Group and other corporate chiefs about accounting rules are nothing new, Mr. Turner said. During his years as the S.E.C.'s chief accountant, from 1998 to 2001, officials from the New York Stock Exchange would regularly request exemptions from reporting rules, he said. "I never once agreed to what they were asking for," Mr. Turner recalled.

Clearly, investors will be hurt the most if this provision of Sarbanes-Oxley is watered down. Which raises a question, according to Mr. Turner: Why should a public company be able to raise money from investors if it can't generate accurate reports for them?

Twitter: @gmorgenson

A version of this article appears in print on Sept. 10, 2017, on Page BU1 of the New York edition with the headline: Oversight Law Under Attack Aids Investors

BLACKROCK®

VIEWPOINT

JUN 2018
UPDATE

US Money Market Fund Reform: Assessing the Impact

"The MMF reforms were not fully implemented until October 2016, and I am concerned that making major changes at this time could be disruptive to the short-term funding markets."

— Hon. Jay Clayton, Chairman, Securities and Exchange Commission Oct. 5, 2017

In 2014, reforms for US money market funds (MMFs) were adopted to address problems that surfaced during the 2008 financial crisis (2008 Crisis).[1] The reforms resulted from years of debate that included consideration of many reform options. Among the final reforms was a requirement that institutional prime and municipal MMFs convert to floating net asset value (FNAV) funds from constant net asset value (CNAV). In general, this led to net outflows from institutional prime and municipal MMFs. Though, recently, we have observed renewed interest in both prime and municipal strategies, albeit at a measured pace, suggesting the decline in these strategies may not be permanent.

Some have called for a roll back of the MMF reforms due to concerns about rising borrowing costs for municipal issuers. In contrast, an October 2017 letter written by Securities and Exchange Commission (SEC) Chairman, Jay Clayton, stated: "I am concerned that making major changes at this time could be disruptive to the short-term funding markets."[2] In our view, conclusive data-driven analysis should precede policy action. To date, analyses of the impact of MMF reform on borrowing costs are, at best, inconclusive. Notably, MMF reforms were initiated during a period of historically low interest rates (and hence, historically low borrowing costs) that was followed by several interest rate increases by the Federal Reserve and US tax reform. It is, therefore, not surprising that borrowing costs for all issuers have increased along with the Federal Reserve rate hikes, irrespective of MMF reform.

Over a year and a half after implementation, the impact and effectiveness of MMF reform should be reviewed. As the primary regulator of MMFs, the SEC is best placed to perform this analysis. We do not believe a roll back of the rules is advisable without first studying the effects of MMF reforms and the implications of any potential changes.

In this *ViewPoint*...

- MMF reforms were adopted to address structural weaknesses that led to government support for money markets in 2008.
- Efforts to roll back reforms must carefully consider the reasons why these rules were implemented in the first place.
- Arguments that MMF reform is driving higher borrowing costs for municipalities fail to fully consider the rising interest rate environment in which MMF reform was implemented, as interest rates are a primary driver of borrowing costs.
- While there is evidence of a temporary market dislocation due to MMF reform, the data supporting longer-term impacts is inconclusive.
- The SEC should conduct a study of the effects of MMF reform before determining whether rule changes are necessary or appropriate.
- We do not believe a roll back of the rules is advisable without first studying the effects of MMF reforms and the implications of any potential changes.

The opinions expressed are as of June 2018 and may change as subsequent conditions vary.

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Key Observations and Recommendations

MMFs experienced challenges during the 2008 Crisis that led to calls for reform.

- The "breaking of the buck" by the Reserve Primary Fund resulted in historic outflows across the MMF industry.
- Government intervention helped calm investors and stabilize outflows.
- Subsequently, MMFs became a priority issue for post-Crisis reform.

The Securities and Exchange Commission (SEC) adopted reforms for US MMFs in 2010 to require more conservative portfolio construction, followed by structural reforms in 2014.

- Among the 2014 reforms was a requirement that institutional prime and municipal MMFs adopt a floating NAV.
- The final compliance date for the structural reforms was October 2016.

The extensive reforms to MMFs warrant review to fully understand the impacts on financial stability, short-term funding markets, issuers, and MMF investors.

- We recommend that the SEC conduct this study, as the SEC is the primary regulator of MMFs and their sponsors, as well as US capital markets.
- Based on this analysis, policy makers can determine if any additional modifications to rules for US MMFs are warranted.
- We do not believe a roll back of the rules is advisable without first studying the effects of MMF reforms and the implications of any potential changes.

Short-term funding markets are complex; borrowing costs reflect numerous factors.

- Monetary policy, issuer credit quality, tax reform, and supply and demand are just a few of the factors that need to be considered.
- Claims that MMF reform has caused rising borrowing costs for municipal issuers do not fully consider all relevant factors.
- Objective analyses of borrowing costs must control for the fact that MMF reform coincided with a rising interest rate environment.
- Following seven years of near zero short-term rates, the Federal Open Market Committee (FOMC) raised the Fed Funds target rate six times between December 2015 and May 2018. In addition, on June 14, 2018, the FOMC announced an additional rate hike.

MMF Reform: How Did We Get Here?

Although MMFs had existed for several decades prior to 2008, the 2008 Crisis exposed structural weaknesses in MMFs. Specifically, the "breaking of the buck" by the Reserve Primary Fund, a MMF that held substantial amounts of Lehman Brothers' commercial paper in September 2008, led to historic net outflows across the MMF industry, as illustrated in Exhibit 1. To stabilize MMFs, the Federal Reserve and the US Treasury Department initiated several programs to help stabilize the MMF market.[3] For example, on September 19, 2008, the US Treasury Department announced the Temporary Guarantee Program for Money Markets Funds, which temporarily protected MMF shareholders from losses.[4]

Given this unprecedented government intervention into money markets, it is not surprising that policy makers sought to implement reforms to avoid such a scenario in the future. While one can debate the necessity of some aspects of the US MMF reforms, the reality is that the SEC approved these rule changes after several years of debate and data-driven analyses. Importantly, fund sponsors were given time to implement changes, and market participants have largely adapted.

Exhibit 1: Assets in 2a-7 MMFs
2006-2018

Source: iMoneyNet. As of May 31, 2018.

Exhibit 2: Selected Elements of Current SEC Regulations for MMFs

Investor Type	MMF Type	NAV	Redemption Fee	Redemption Gate
Institutional	Prime	Floating	Up to 2%	Up to 10 business days
Institutional	Municipal / Tax Exempt	Floating	Up to 2%	Up to 10 business days
Institutional / Retail	Government	Stable	None*	None*
Retail	Prime	Stable	Up to 2%	Up to 10 business days
Retail	Municipal / Tax Exempt	Stable	Up to 2%	Up to 10 business days

Source: SEC. *Government MMFs are permitted but not required to impose redemption liquidity fees and restrictions.
Grey box highlights new requirements that had not been in place prior to the 2014 reforms.

As shown in Exhibit 2, among the structural reforms adopted in the 2014 reforms was a requirement for institutional prime and municipal MMFs to convert to FNAV, meaning they are no longer permitted to use amortized cost accounting to round the NAV to a stable $1.00 per share price. The reforms also require both retail and institutional prime and municipal MMFs to have the ability to implement a redemption liquidity fee and redemption gates during times of stress.

The final SEC reforms followed several years of vigorous debate about the way forward for MMFs, which included the consideration of many alternative solutions. Exhibit 3 provides a timeline of MMF reform discussions from the 2008 Crisis until July 2014 when the reforms were finalized by the SEC. During this period, many MMF investors were challenged by the lack of certainty around the future of MMFs. We believe materially altering Rule 2a-7 again would create uncertainty for investors and potentially disruptions to the short-term funding markets. As such, new reforms should only be undertaken if there is conclusive evidence that MMF reform has resulted in unintended consequences. This calls for careful study by the SEC before any policy actions are taken.

Exhibit 3: Major Reform Milestones

Date	Milestone
Sep '08	Reserve Primary Fund "broke the buck"
Feb '10	SEC adopted certain Rule 2a-7 amendments strengthening the liquidity of the portfolios; effective May 2010
Mar '11	SEC proposed rules to eliminate certain references to credit ratings in MMF forms
Sep '12	Treasury Secretary Geithner letter urging SEC and industry to re-take up issue of reform
Nov '12	FSOC* releases reform proposal for comment
Jun '13	SEC releases proposal including conversion to FNAV for prime institutional MMFs
Mar '14	SEC issues 4 economic studies regarding MMFs, solicits public comment
Jul '14	SEC finalizes MMF reforms; effective October 2016

Source: BlackRock.
*FSOC stands for Financial Stability Oversight Council.

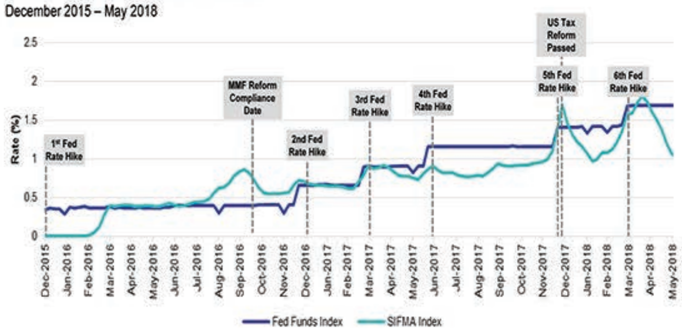
MMF Reform and Cost of Funding for Municipalities: Context and Timing are Important Factors

Recognizing that MMFs play an important role in the economy by providing a source of short-term funding to commercial and municipal borrowers, policy makers should study the potential implications of these reforms. That said, it is important that analyses do not consider isolated data points, but rather take a comprehensive approach that considers the broader context, as short-term funding markets are complex and borrowing costs reflect numerous factors.

For example, some critics of MMF reform have argued that borrowing costs for municipalities have increased sharply as a result of the MMF reforms. They cite a 91 basis point increase in the SIFMA Municipal Swap Index (SIFMA Index) between January 2016 and August 2017 as the basis for this conclusion.[5] The SIFMA Index represents the average yield on 7-day municipal Variable Rate Demand Notes (VRDNs).[6] This index is widely used as a benchmark to measure the average cost of borrowing for municipal issuers. When considered in isolation, this increase in funding costs might be cause for concern. However, when assessing borrowing costs for issuers, the interest rate environment is important to consider, given that monetary policy is a key driver of borrowing costs.

As shown in Exhibit 4, which plots the SIFMA Index and the Fed Funds rate, the FOMC increased the Fed Funds target rate six times between December 2015 and May 2018.[7] As such, the implementation of US MMF structural reforms directly coincided with a rising interest rate environment. In addition, during this window, the Fed announced the end of

Exhibit 4: Fed Funds and SIFMA Index
December 2015 – May 2018

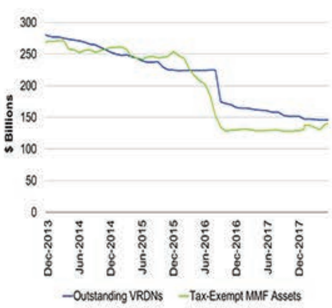


Source: Bloomberg, BlackRock. As of May 31, 2018.

Quantitative Easing (QE), and began reducing its balance sheet.[8] While the SIFMA Index and Fed Funds rate largely move in line with each other, there are periods of divergence. These include both periods where the SIFMA Index is below and above Fed Funds. For example, in late 2015 to early 2016, the SIFMA Index diverged from the Fed Funds rate when assets of Tax Exempt MMFs exceeded inventories of available VRDNs, creating a scenario in which high demand was driving prevailing rates in VRDNs lower. This dynamic is shown in Exhibit 5. Likewise, the SIFMA Index spiked just as MMF reforms approached the October 2016 compliance date. The SIFMA Index spiked again at the end of 2017 due to a dramatic increase in municipal issuance as a result of US tax reform. Exhibit 4 shows the SIFMA Index below and above the Fed Funds rate at different points in time. Given these fluctuations, any analysis will be sensitive to the start and end dates of the study, requiring careful consideration before drawing conclusions.

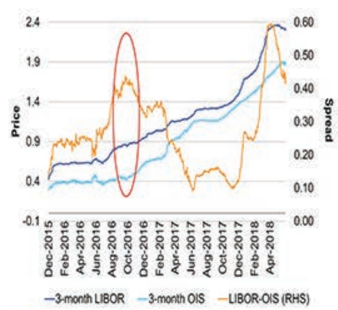
Looking more closely at the spike in October 2016, the months just before and just after MMF reform implementation represented a period of uncertainty. Since fund managers were unsure, at the time, as to the amount of assets that would flow out of prime and municipal MMFs, as the final compliance date for reforms approached, most institutional prime and municipal MMF managers increased the amounts of liquidity they were holding and shortened the maturity profiles of their portfolios. This dynamic appears to have contributed to a temporary rise in borrowing costs, as the demand for shorter-dated assets increased relative to supply. The dynamic was most noticeable in the spike in the LIBOR-OIS spread, as adjustments in commercial paper markets[9] were similar to municipal markets. As shown in Exhibit 6, this dislocation was temporary in nature and reversed relatively quickly thereafter.

Exhibit 5: Tax Exempt MMF Assets v. VRDNs Outstanding



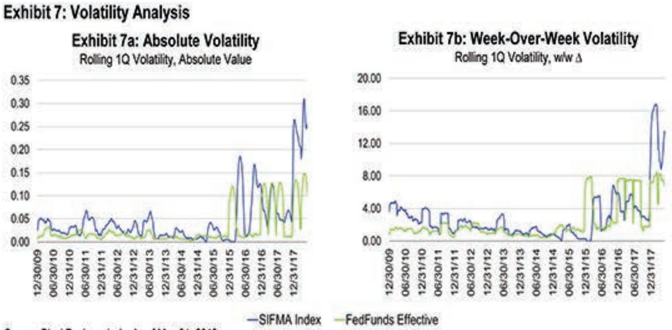
Source: Barclays. As of May 31, 2018.

Exhibit 6: LIBOR-OIS Spread



Source: Bloomberg. As of May 31, 2018.

Exhibit 7: Volatility Analysis



Source: BlackRock analysis. As of May 31, 2018.

In the months leading up to and shortly following October 2016 when the reforms were fully implemented, municipal MMF outflows contributed to a period of elevated dealer VRDN inventory, as municipal MMFs, which had been traditional purchasers of VRDNs, had less demand. This dynamic can be observed in Exhibit 5. As a result, VRDN yields were higher to attract crossover and short duration buyers, creating a temporary dislocation in the SIFMA Index.

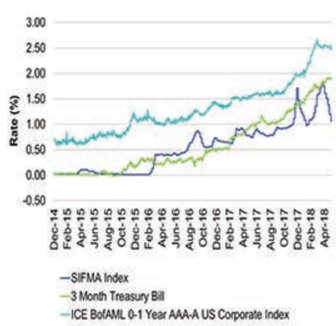
To further analyze the impact of interest rate dynamics on municipal borrowing costs, we performed a volatility analysis of the SIFMA Index and the Fed Funds rate. Exhibit 7a looks at the absolute volatility of each rate, and Exhibit 7b depicts the volatility of week over week changes in each rate.[10] While this analysis shows that there was volatility around MMF reform and US tax reform, we do not observe any volatility regime shift for the SIFMA Index relative to the Fed Funds rate. This further supports the conclusion that much of the increase in borrowing costs for municipalities is a product of the rising interest rate environment. We note that this analysis reflects a simple approach and there are several other factors that can impact municipal funding, including issuer credit quality, tax reforms, and supply and demand. These dynamics would need to be considered in order to develop a comprehensive assessment of the impact of MMF reform. We encourage the SEC to undertake this comprehensive analysis.

While commentators have pointed to an increase in borrowing costs for municipal issuers as a direct impact of MMF reform, the evidence to support this assertion is not conclusive when the interest rate environment is taken into account. As shown in Exhibit 4, between December 2015 and May 2018, the Fed Funds rate increased from 0.13% to 1.7%, a 157 basis point increase. During this same time period, the SIFMA Index increased from 0.01% to 1.06%, a 105 basis point increase. With this context in mind, borrowing costs for municipalities appear in line with what would be expected during this period of interest rate normalization.

One counterargument that has been noted is that interest rate dynamics do not fully explain the trend in increased borrowing costs for municipalities, as there is a yield differential between taxable and tax exempt bonds that is not fully depicted in this data.[11] We believe this differential exists given the supply-demand dynamics that occurred around money market reform and again around US tax reform, but that ultimately the market did and will normalize. Further, we believe the reduction in the corporate tax rate resulting from tax reform is causing the market to find a new equilibrium that differs from historical periods.

Importantly, aside from the temporary dislocation around the time of the MMF reform compliance date, borrowing costs in municipal markets have followed a similar trend as other short-term taxable fixed income markets. This is illustrated in Exhibit 8, which compares the SIFMA Index to the 3-month Treasury bill, and the ICE BofAML 0-1 Year AAA-A US Corporate Index, which is a measure of short-term funding rates for highly rated corporates.

Exhibit 8: Short-Term Interest Rates – Multiple Markets



Source: Bloomberg. As of May 31, 2018.

Conclusion

In sum, while it is no question that there has been an increase in borrowing costs for issuers (correlation), when we control for the rising interest rate environment and the effects of tax reform, the evidence to support a causal relationship between MMF reform and a *permanent* increase in municipal borrowing costs is inconclusive. Temporary market impacts have been observed over the course of implementation of MMF reforms, but this does not appear to have had a permanent impact beyond the natural increase in borrowing costs associated with interest rate normalization. Clearly, more comprehensive analysis will need to be performed before any conclusions can be drawn.

As was suggested at the time of MMF reform, MMF reforms should be monitored for their effectiveness in mitigating financial stability risks.[12] Now that full implementation has taken place, a review of the impacts on financial stability, short-term funding markets, issuers, and MMF investors is warranted. In light of the 2008 Crisis and the experience of MMFs, this review needs to consider the effectiveness of MMF reforms as well as identify any unintended consequences. As the regulator for MMFs and their sponsors, the SEC is best positioned to conduct this review. We do not believe a roll back of the rules is advisable without first studying the effects of MMF reforms and the implications of any potential changes.

Endnotes

1. See Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47735 (Aug. 14, 2014); Money Market Fund Reform, 75 Fed. Reg. 10060 (Mar. 4, 2010) (Release No. IC-29132; File Nos. S7-11-09, S7-20-09).
2. SEC Chairman Jay Clayton, Letter to Hon. Carolyn Maloney, Ranking Member, Subcommittee on Capital Markets, Securities and Investment, Committee on Financial Services (Oct. 5, 2017).
3. Details of the Fed's crisis era liquidity support programs can be found here: https://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm.
4. US Treasury Dept., Treasury Announces Temporary Guarantee Program for Money Market Funds (Sep. 6, 2008), available at https://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx.
5. Treasury Strategies, Inc. "Public Sector Funding Costs: A Rebuttal."
6. Variable Rate Demand Notes (VRDNs) are floating rate municipal instruments that carry a 1 or 7 day put option. VRDN's typically represent approximately 80% of the securities in municipal money market funds (source: iMoneyNet)
7. The FOMC announced a seventh rate hike (since Dec. 2015) on Jun. 14, 2018. Federal Reserve, FOMC's target federal funds rate or range, change (basis points) and level as of June 14, 2018, available at https://www.federalreserve.gov/monetarypolicy/openmarket.htm.
8. Federal Reserve, Press Release, Federal Reserve issues FOMC statement (Sep. 20, 2017), available at https://www.federalreserve.gov/newsevents/pressreleases/monetary20170920a.htm.
9. Commercial paper is often used by Prime MMFs as an important investment. Prime MMFs saw a decrease in assets of $1 trillion as a result of MMF reform, as many MMF investors moved into Government MMFs. The LIBOR-OIS spread measures the difference between two important interest rates, the London Interbank Offered Rate (LIBOR) and the Overnight Indexed Swap (OIS) rate. This is often used as a key measure of credit risk in the banking sector.
10. 2017 year end volatility in SIFMA Index resulted from increased municipal issuance in advance of tax reform.
11. Treasury Strategies, Inc. "Public Sector Funding Costs: A Rebuttal."
12. Statement from Secretary Lew on the Final Money Market Mutual Fund Rule by the SEC (Jul. 23, 2014), available at https://www.treasury.gov/press-center/press-releases/Pages/jl2583.aspx.

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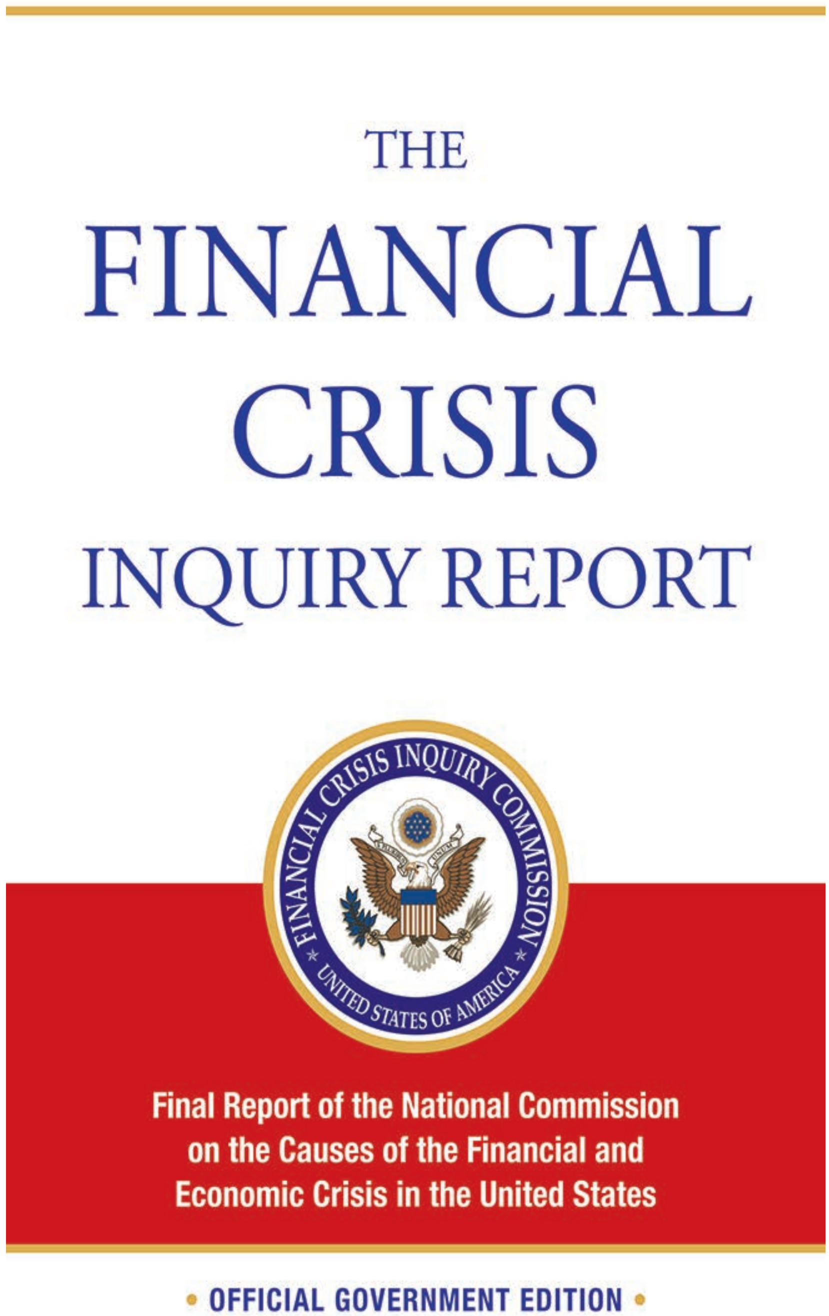
THE
FINANCIAL
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UNITED STATES OF AMERICA
Final Report of the National Commission
on the Causes of the Financial and
Economic Crisis in the United States
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On Monday, September 15, the Dow Jones Industrial Average fell more than 500 points, or 4%, the largest single-day point drop since the 9/11 terrorist attacks. These drops would be exceeded on September 29—the day that the House of Representatives initially voted against the $700 billion Troubled Asset Relief Program (TARP) proposal to provide extraordinary support to financial markets and firms—when the Dow Jones fell 7% and financial stocks fell 16%. For the month, the S&P 500 would lose $889 billion of its value, a decline of 9%—the worst month since September 2002.

And specific institutions would take direct hits.

MONEY MARKET FUNDS: "DEALERS WEREN'T EVEN PICKING UP THEIR PHONES"

When Lehman declared bankruptcy, the Reserve Primary Fund had $785 million invested in Lehman's commercial paper. The Primary Fund was the world's first money market mutual fund, established in 1971 by Reserve Management Company. The fund had traditionally invested in conservative assets such as government securities and bank certificates of deposit and had for years enjoyed Moody's and S&P's highest ratings for safety and liquidity.

In March 2006, the fund had advised investors that it had "slightly underperformed" its rivals, owing to a "more conservative and risk averse manner" of investing—"for example, the Reserve Funds do not invest in commercial paper."[11] But immediately after publishing this statement, it quietly but dramatically changed that strategy. Within 18 months, commercial paper grew from zero to one-half of Reserve Primary's assets. The higher yields attracted new investors and the Reserve Primary Fund was the fastest-growing money market fund complex in the United States in 2006, 2007, and 2008—doubling in the first eight months of 2008 alone.[12]

Earlier in 2008, Primary Fund's managers had loaned Bear Stearns money in the repo market up to two days before Bear's near-collapse, pulling its money only after Bear CEO Alan Schwartz appeared on CNBC in the company's final days, Primary Fund Portfolio Manager Michael Luciano told the FCIC. But after the government-assisted rescue of Bear, Luciano, like many other professional investors, said he assumed that the federal government would similarly save the day if Lehman or one of the other investment banks, which were much larger and posed greater apparent systemic risks, ran into trouble. These firms, Luciano said, were too big to fail.[13]

On September 15, when Lehman declared bankruptcy, the Primary Fund's Lehman holdings amounted to 1.2% of the fund's total assets of $62.4 billion. That morning, the fund was flooded with redemption requests totaling $10.8 billion. State Street, the fund's custodian bank, initially helped the fund meet those requests, largely through an existing overdraft facility, but stopped doing so at 10:10 A.M. With no means to borrow, Primary Fund representatives reportedly described State Street's action as "the kiss of death" for the Primary Fund.[14] Despite public assurances from the fund's investment advisors, Bruce Bent Sr. and Bruce Bent II, that the fund was committed to maintaining a $1.00 net asset value, investors requested an additional $29 billion later on Monday and Tuesday, September 16.[15]

Meanwhile, on Monday, the fund's board had determined that the Lehman paper was worth 80 cents on the dollar. That appraisal had quickly proved optimistic. After the market closed Tuesday, Reserve Management publicly announced that the value of its Lehman paper was zero, "effective 4:00PM New York time today." As a result, the fund broke the buck.[16] Four days later, the fund sought SEC permission to officially suspend redemptions.

Other funds suffering similar losses were propped up by their sponsors. On Monday, Wachovia's asset management unit, Evergreen Investments, announced that it would support three Evergreen mutual funds that held about $540 million in Lehman paper. On Wednesday, BNY Mellon announced support for various funds that held Lehman paper, including the $22 billion Institutional Cash Reserves fund and four of its trademark Dreyfus funds. BNY Mellon would take an after-tax charge of $425 million because of this decision. Over the next two years, 62 money market funds—36 based in the United States, 26 in Europe[17]—would receive such assistance to keep their funds from breaking the buck.

After the Primary Fund broke the buck, the run took an ominous turn: it even slammed money market funds with no direct Lehman exposure. This lack of exposure was generally known, since the SEC requires these funds to report details on their investments at least quarterly. Investors pulled out simply because they feared that their fellow investors would run first. "It was overwhelmingly clear that we were staring into the abyss—that there wasn't a bottom to this—as the outflows picked up steam on Wednesday and Thursday," Fed economist Patrick McCabe told the FCIC. "The overwhelming sense was that this was a catastrophe that we were watching unfold."[18]

"We were really cognizant of the fact that there weren't backstops in the system that were resilient at that time," the Fed's Michael Palumbo said. "Liquidity crises, by their nature, invoke rapid, emergent episodes—that's what they are. By their nature, they spread very quickly."[19]

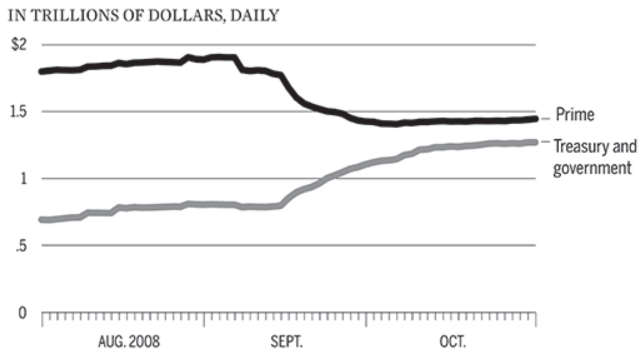
An early and significant casualty was Putnam Investments' $12 billion Prime Money Market Fund, which was hit on Wednesday with a wave of redemption requests. The fund, unable to liquidate assets quickly enough, halted redemptions. One week later, it was sold to Federated Investors.

Within a week, investors in prime money market funds—funds that invested in highly rated securities—withdrew $349 billion; within three weeks, they withdrew another $85 billion. That money was mostly headed for other funds that bought only Treasuries and agency securities; indeed, it was more money than those funds could invest, and they had to turn people away[20] (see figure 20.2). As a result of the unprecedented demand for Treasuries, the yield on four-week Treasuries fell close to 0%, levels not seen since World War II.

Money market mutual funds needing cash to honor redemptions sold their now illiquid investments. Unfortunately, there was little market to speak of. "We heard

Investments in Money Market Funds

In a flight to safety, investors shifted from prime money market funds to money market funds investing in Treasury and agency securities.



SOURCE: Crane Data

Figure 20.2

anecdotally that the dealers weren't even picking up their phones. The funds had to get rid of their paper; they didn't have anyone to give it to," McCabe said.[21]

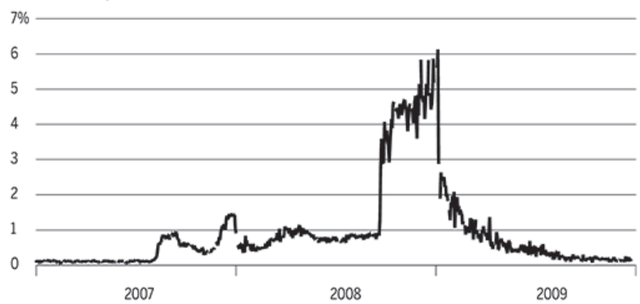
And holding unsecured commercial paper from any large financial institution was now simply out of the question: fund managers wanted no part of the next Lehman. An FCIC survey of the largest money market funds found that many were unwilling to purchase commercial paper from financial firms during the week after Lehman. Of the respondents, the five with the most drastic reduction in financial commercial paper cut their holdings by half, from $58 billion to $29 billion.[22] This led to unprecedented increases in the rates on commercial paper, creating problems for borrowers, particularly for financial companies, such as GE Capital, CIT, and American Express, as well as for nonfinancial corporations that used commercial paper to pay their immediate expenses such as payroll and inventories. The cost of commercial paper borrowing spiked in mid-September, dramatically surpassing the previous highs in 2007 (see figure 20.3).

"You had a broad-based run on commercial paper markets," Geithner told the FCIC. "And so you faced the prospect of some of the largest companies in the world and the United States losing the capacity to fund and access those commercial paper markets."[23] Three decades of easy borrowing for those with top-rated credit in a very liquid market had disappeared almost overnight. The panic threatened to disrupt the payments system through which financial institutions transfer trillions of dollars in

Cost of Short-Term Borrowing

During the crisis, the cost of borrowing for lower-rated nonfinancial firms spiked.

IN PERCENT, DAILY



NOTE: Shown is the spread between the rate paid by second-tier rated nonfinancial companies (A2/P2) that borrowed by issuing 30-day commercial paper and the rate paid on similar paper by the best-rated companies.
SOURCE: Federal Reserve Board of Governors

Figure 20.3

cash and assets every day and upon which consumers rely—for example, to use their credit cards and debit cards. "At that point, you don't need to map out which particular mechanism—it's not relevant anymore—it's become systemic and endemic and it needs to be stopped," Palumbo said.[24]

The government responded with two new lending programs on Friday, September 19. Treasury would guarantee the $1 net asset value of eligible money market funds, for a fee paid by the funds.[25] And the Fed would provide loans to banks to purchase high-quality-asset-backed commercial paper from money market funds.[26] In its first two weeks, this program loaned banks $150 billion, although usage declined over the ensuing months. The two programs immediately slowed the run on money market funds.

With the financial sector in disarray, the SEC imposed a temporary ban on short-selling on the stocks of about 800 banks, insurance companies, and securities firms. This action, taken on September 18, followed an earlier temporary ban put in place over the summer on naked short-selling—that is, shorting a stock without arranging to deliver it to the buyer—of 19 financial stocks in order to protect them from "unlawful manipulation."

Meanwhile, Treasury Secretary Henry Paulson and other senior officials had decided they needed a more systematic approach to dealing with troubled firms and troubled markets. Paulson started seeking authority from Congress for TARP. "One thing that was constant about the crisis is that we were always behind. It was always morphing and manifesting itself in ways we didn't expect," Neel Kashkari, then assistant secretary of the treasury, told the FCIC. "So we knew we'd get one shot at this authority and it was important that we provided ourselves maximum firepower and maximum flexibility. We specifically designed the authority to allow us basically to do whatever we needed to do." Kashkari "spent the next two weeks basically living on Capitol Hill."[27] As discussed below, the program was a tough sell.

MORGAN STANLEY: "NOW WE'RE THE NEXT IN LINE"

Investors scrutinized the two remaining large, independent investment banks after the failure of Lehman and the announced acquisition of Merrill. Especially Morgan Stanley. On Monday, September 15, the annual cost of protecting $10 million in Morgan Stanley debt through credit default swaps jumped to $682,000—from $363,000 on Friday—about double the cost for Goldman. "As soon as we come in on Monday, we're in the eye of the storm with Merrill gone and Lehman gone," John Mack, then Morgan Stanley's CEO, said to the FCIC. He later added, "Now we're the next in line."[28]

Morgan Stanley officials had some reason for confidence. On the previous Friday, the company's liquidity pool was more than $130 billion—Goldman's was $120 billion[29]—and, like Goldman, it had passed the regulators' liquidity stress tests months earlier. But the early market indicators were mixed. David Wong, Morgan Stanley's treasurer, heard early from his London office that several European banks were not accepting Morgan Stanley as a counterparty on derivatives trades.[30] He called those banks and they agreed to keep their trades with Morgan Stanley, at least for the time being. But Wong well knew that rumors about derivatives counterparties fleeing through novations had contributed to the demise of Bear and Lehman. Repo lenders, primarily money market funds, likewise did not panic immediately. On Monday, only a few of them requested slightly more collateral.[31]

But the relative stability was fleeting. Morgan Stanley immediately became the target of a hedge fund run. Before the financial crisis, it had typically been prime brokers like Morgan Stanley who were worried about their exposures to hedge fund clients. Now the roles were reversed. The Lehman episode had revealed that because prime brokers were able to reuse clients' assets to raise cash for their own activities, clients' assets could be frozen or lost in bankruptcy proceedings.[32]

To protect themselves, hedge funds pulled billions of dollars in cash and other assets out of Morgan Stanley, Merrill, and Goldman in favor of prime brokers in bank holding companies, such as JP Morgan; big foreign banks, such as Deutsche Bank and Credit Suisse; and custodian banks, such as BNY Mellon and Northern Trust, which they believed were safer and more transparent. Fund managers told the FCIC that some prime brokers took aggressive measures to prevent hedge fund customers from demanding their assets. For example, "Most [hedge funds] request cash movement from [prime brokers] primarily through a fax," the hedge fund manager Jonathan Wood told the FCIC. "What tends to happen in very stressful times is those

Lehman for an indefinite time period while Lehman searched for a buyer. That asset revaluation would later have come under intense legal scrutiny, especially given the likely large and potentially uncapped cost to the taxpayer. In the meantime, other creditors to Lehman could have cashed out at 100 cents on the dollar, leaving taxpayers holding the bag for losses.

Fed Chairman Bernanke, his general counsel Scott Alvarez, and New York Fed general counsel Thomas C. Baxter Jr. all argued in sworn testimony that this option would not have been legal. Bernanke suggested that it also would have been unwise because, in effect, the Fed would have been providing an open-ended commitment to allow Lehman to shop for a buyer. Bernanke testified that such a loan would merely waste taxpayer money for an outcome that was quite unlikely to change.

Based on their actions to deal with other failing financial institutions in 2008, we think these policymakers would have taken any available option they thought was legal and viable. This was an active team that was in all cases erring on the side of intervention to reduce the risk of catastrophic outcomes. Fed Chairman Bernanke said that he "was very, very confident that Lehman's demise was going to be a catastrophe."[9] We find it implausible to conclude that they would have broken pattern on this one case at such an obviously risky moment if they had thought they had another option.

Some find it inconceivable that policymakers could be confronted with a situation in which there was no legal and viable course of action to avoid financial catastrophe. In this case, that is what happened.

THE SHOCK AND THE PANIC

Conventional wisdom is that the failure of Lehman Brothers triggered the financial panic. This is because Lehman's failure was unexpected and because the debate about whether government officials could have saved Lehman is so intense.

The focus on Lehman's failure is too narrow. The events of September 2008 were a chain of one firm failure after another:

- Sunday, September 7, FHFA put Fannie Mae and Freddie Mac into conservatorship.
- This was followed by "Lehman weekend at the New York Fed," which was in fact broader than just Lehman. At the end of that weekend, Bank of America had agreed to buy Merrill Lynch, Lehman was filing for bankruptcy, and AIG was on the verge of failure.
- Monday, September 15, Lehman filed for Chapter 11 bankruptcy protection.
- Tuesday, September 16, the Reserve Primary Fund, a money market mutual fund, "broke the buck" after facing an investor run. Its net asset value declined below $1, meaning that an investment in the fund had actually lost money. This is a critical psychological threshold for a money market fund. On the same day, the Fed approved an $85 billion emergency loan to AIG to prevent it from sudden failure.

- Thursday, September 18, the Bush Administration, supported by Fed Chairman Bernanke, proposed to Congressional leaders that they appropriate funds for a new Troubled Asset Relief Program (TARP) to recapitalize banks.
- Friday, September 19, the $700 billion TARP was publically announced.
- Sunday, September 21, the Fed agreed to accept Goldman Sachs and Morgan Stanley as bank holding companies, putting them under the Fed's regulatory purview. After this, there were no large standalone investment banks remaining in the United States.
- Thursday, September 25, the FDIC was appointed receiver of Washington Mutual and later sold it to JPMorgan.
- Monday, September 29, the TARP bill failed to pass the House of Representatives, and the FDIC agreed to provide assistance to facilitate a sale of Wachovia to Citigroup.
- Wednesday, October 1, the Senate passed a revised TARP bill. Two days later, the House passed it, and the President signed it into law. Wells Fargo, rather than Citigroup, bought Wachovia.
- As the month progressed, interbank lending rates soared, indicating the heightened fear and threatening a complete freeze of lending.

The financial panic was triggered and then amplified by the close succession of these events, and not just by Lehman's failure. Lehman was the most unexpected bad news in that succession, but it's a mistake to attribute the panic entirely to Lehman's failure. There was growing realization by investors that mortgage losses were concentrated in the financial system, but nobody knew precisely where they lay.

Conclusion:

In quick succession in September 2008, the failure, near-failure, or restructuring of ten firms triggered a global financial panic. Confidence and trust in the financial system began to evaporate as the health of almost every large and midsize financial institution in the United States and Europe was questioned.

We briefly discuss two of these failures.

The Reserve Primary Fund

The role of the Reserve Primary Fund's failure in triggering the panic is underappreciated. This money market mutual fund faced escalating redemption requests and had to take losses from its holdings of Lehman debt. On Tuesday, September 16, it broke the buck in a disorganized manner. Investors who withdrew early recouped 100 cents on the dollar, with the remaining investors bearing the losses. This spread fear among investors that other similarly situated funds might follow. By the middle of the following week, prime money market mutual fund investors had withdrawn $349 billion.

When the SEC was unable to reassure market participants that the problem was isolated, money market mutual fund managers, in anticipation of future runs, refused to renew the commercial paper they were funding and began to convert their holdings to Treasuries and cash. Corporations that had relied on commercial paper markets for short-term financing suddenly had to draw down their backstop lines of credit. No one had expected these corporate lines of credit to be triggered simultaneously, and this "involuntary lending" meant that banks would have to pull back on other activities.

The role of Fannie Mae and Freddie Mac in causing the crisis

The government-sponsored enterprises Fannie Mae and Freddie Mac were elements of the crisis in several ways:

- They were part of the securitization process that lowered mortgage credit quality standards.
- As large financial institutions whose failures risked contagion, they were massive and multidimensional cases of the too big to fail problem. Policymakers were unwilling to let them fail because:
  - Financial institutions around the world bore significant counterparty risk to them through holdings of GSE debt;
  - Certain funding markets depended on the value of their debt; and
  - Ongoing mortgage market operation depended on their continued existence.
- They were by far the most expensive institutional failures to the taxpayer and are an ongoing cost.

There is vigorous debate about how big a role these two firms played in securitization relative to "private label" securitizers. There is also vigorous debate about why these two firms got involved in this problem. We think both questions are less important than the multiple points of contact Fannie Mae and Freddie Mac had with the financial system.

These two firms were guarantors and securitizers, financial institutions holding enormous portfolios of housing-related assets, and the issuers of debt that was treated like government debt by the financial system. Fannie Mae and Freddie Mac did not by themselves cause the crisis, but they contributed significantly in a number of ways.

THE SYSTEM FREEZING

Following the shock and panic, financial intermediation operated with escalating frictions. Some funding markets collapsed entirely. Others experienced a rapid blowout in spreads following the shock and stabilized slowly as the panic subsided and the government stepped in to backstop markets and firms. We highlight three funding markets here:

- **Interbank lending.** Lending dynamics changed quickly in the federal funds market where banks loan excess reserves to one another overnight. Even large

DOW JONES, A NEWS CORP COMPANY

DJIA 24297.92 0.19% ▲ Nasdaq 7549.69 0.23% ▲ U.S. 10 Yr 2/32 Yield 2.876% ▲ Crude Oil 69.34 1.85% ▲ Euro 1.1671 -0.27% ▼

THE WALL STREET JOURNAL.

https://www.wsj.com/articles/firms-with-troubled-brokers-are-often-behind-sales-of-private-stakes-1529838000

MARKETS

Firms With Troubled Brokers Are Often Behind Sales of Private Stakes

Surge in private-placement sales is fueling concerns about how they're sold and what selling perks or markups the brokers get

Finra has warned in the past about "fraud and sales practice abuses" by firms and brokers in the private-placement market. PHOTO: STEPHEN VOSS FOR THE WALL STREET JOURNAL

By Jean Eaglesham and Coulter Jones

Updated June 24, 2018 3:33 p.m. ET

Securities firms with an unusually high number of troubled brokers are selling tens of billions of dollars a year of private stakes in companies, often targeting seniors, an analysis by The Wall Street Journal found.

The emerging trend could mean that unsuspecting investors will be exposed to losses or fraud in a market that has grown sharply in recent years.

In a review of more than a million regulatory records, the Journal identified over a hundred firms where 10% to 60% of the in-house brokers had three or more investor complaints, regulatory actions, criminal charges or other red flags on their records —significant outliers in the investment community. These brokerages helped sell to investors more than $60 billion of stakes in private companies, known as private placements.

Sales of private placements are surging, as part of a broader rise in private capital markets, fueling concerns among investor representatives about how the products are sold. More than 1,200 firms sold around $710 billion of private placements last year, and sales for the first five months of this year are on track to top that record-setting tally, the Journal found.

HOW THE JOURNAL DID THE MATH

- The Wall Street Journal built a database of more than 320,000 filings for private placements, known as Form Ds

Private placements, which could be stakes in anything from an apartment complex or oil well to a biotech company, can offer investors higher returns than publicly traded stocks and bonds. But there's typically less information available about the companies, increasing the risks for investors.

The clustering of higher-risk brokers underscores regulator worries about the largely unpoliced market.

"Sales of private placements are so lucrative to the brokerage firms that they are a perennial concern for regulators," said Brad Bennett, a former enforcement chief at brokerage watchdog the Financial Industry Regulatory Authority. Issues on the regulators' radar, he said, include whether the private placement offers a stake in a legitimate business, what selling perks or markups the brokers get, and how it is sold to investors.

Newbridge Securities Corp., in Boca Raton, Fla., for instance, was the biggest outlier among firms with more than 100 brokers, the Journal found: Investors have a one in four chance of getting a broker there with at least three red flags. Regulators sanctioned the firm 20 times—an average of twice a year—over the past decade, with fines of $1.75 million.

Robert Abrams, general counsel at Newbridge, said that they assess each broker before hiring and added that the firm's 180 or so brokers are more likely to have red flags because they deal with investors more than many larger brokerages. "Firms like Newbridge become easy pickings for the lawyers," he said.

Most private placements are restricted to sophisticated investors, such as hedge funds and insurers, seeking alternatives to public stocks and bonds. In some cases, relatively wealthy individuals can get in.

Regulators lean heavily on the hundreds of brokerages to monitor deals, but rich commissions create strong motivations to sell, sometimes without consideration for the investor.

"Firms that permit brokers to peddle these products tend to put fee generation above what is good for their clients," said Andrew Stoltmann, a Chicago-based lawyer who represents investors in claims against brokers. "And brokers who want to generate fees at their clients' expense tend to flock to these firms."

Finra has warned in the past about "fraud and sales practice abuses" by firms and brokers in the market.

Lawyers representing investors say the red-flag firms identified by the Journal tend to hire troubled brokers for their track record in aggressively selling high-commission deals, sometimes using questionable tactics. Firms say their vetting of brokers goes much deeper than the number of red flags.

Most of these firms are small to midsize brokerages, with fewer than 500 brokers, and are spread throughout the country. The big Wall Street firms in general have proportionally fewer brokers dealing direct with investors, and also with multiple red flags. Only 2% of the more than 28,000 brokers at Merrill Lynch, for example, which is the brokerage arm of Bank of America Corp. and one of the biggest national firms, have three or more red flags.

Even though only around 4 out of 10 brokerages sell private placements, these brokerages account for more than half of the 94 firms that Finra expelled since 2013, the analysis found. For example, Texas E&P Partners Inc., a brokerage in Richardson, Texas, was booted last year over its sale of interests in three oil wells. Finra alleged that the firm falsified a document and its owner Mark Plummer failed to return money to investors for a well that was never drilled. In 2016, the year the firm shuttered, more than half its 11 brokers had at least one red flag, the Journal found. Mr. Plummer said "all the Finra allegations were false" and his firm had left the industry before it was expelled.

John Harrison, executive director of the Alternative & Direct Investment Securities Association, an industry organization, said that private-placement deals were a lot more complicated than publicly traded stocks and bonds and are "logically" expected to draw a larger number of complaints.

Some firms draw brokers with red flags. Austin Dutton, a Doylestown, Pa., broker, was hit with the highest fine Pennsylvania regulators have ever imposed on an individual —$200,000—while at Newbridge, before he jumped last fall to another firm called Sandlapper Securities LLC in South Carolina.

At Sandlapper, Mr. Dutton was in familiar company—more than a fifth of the 50 or so brokers had three or more red flags, the Journal found. Mr. Dutton, who has more than a dozen investor complaints, with $1.95 million in pending claims against him, said on his disciplinary record he "vehemently denies all allegations" in the complaints. He didn't respond to requests for comment.

Sandlapper last year helped sell to investors more than two dozen private placements, ranging from an apartment complex in Alpharetta, Ga., to self-storage businesses.

"Sandlapper is one of the brokerages of last resort that will hire individuals with very troubled records," said Nicholas Guiliano, a lawyer who is representing investors suing Newbridge over Mr. Dutton's sales at that firm. He added that some brokerage firms won't hire brokers with multiple red flags.

Gilbert Boyce, a lawyer representing Sandlapper, said it's "grossly unfair" to describe it as a brokerage of last resort. "Sandlapper does not hire everyone with a troubled past and, in fact, rejects many who apply," he said in a statement.

Four days after Mr. Dutton joined Sandlapper, Finra took disciplinary action against the firm and two of its principals. The regulator alleged the two Sandlapper executives set up a middleman company to buy interests in Texan saltwater disposal wells, used in the oil and gas industry, which were then sold to investors by Sandlapper at undisclosed markups of as much as 376%. The fraudulent markups totaled more than $8 million, Finra said.

Mr, Boyce, the lawyer representing Sandlapper and the executives, said they "vehemently deny" Finra's "one-sided compilation of unproven allegations."

How the Journal Did the Math

The Wall Street Journal built a database of more than 320,000 filings for private placements, known as Form Ds, that issuers filed with the Securities and Exchange Commission from September 2008 through May 2018. From those filings, the Journal compiled a list of all the brokerage firms listed as selling private placements and then compared the disciplinary records of stockbrokers currently working at those firms with those of brokers working at firms in the industry as a whole.

The analysis tallied customer complaints, regulatory investigations and actions, firings, criminal charges and other nonfinancial disclosures reported to the Financial Industry Regulatory Authority by the brokers and the firms on their public Finra BrokerCheck records. (This excludes disclosures of personal bankruptcies, tax liens and other financial issues reported on the filings, which may be less directly related to the broker's advice or conduct.)

A review of the percentage of brokers at each firm with three or more nonfinancial disclosures was based on brokerages with 10 or more brokers—about half of all current brokerage firms have at least 10 or more brokers.

To compare the red flags per broker at the typical firm selling private placements with the typical firm in the industry as a whole, the Journal used the median: the firm whose red-flag ratio is exactly in the midpoint of all firms in that category—half of the firms would have a higher ratio of red flags and half would have a lower one. This comparison was based on records filed with Finra, posted to the BrokerCheck website that the Journal collated and includes more than 1.2 million brokers currently and previously registered with Finra as of June.

The Journal also compiled a list of brokerage firms Finra reported expelling from 2013 through May 2018, and reviewed which of those were involved in the sale of private placements.

Coulter Jones and Jean Eaglesham

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Looking behind the declining number of public companies

An analysis of trends in US capital markets

May 2017

EY
Building a better working world

Foreword

It is an undeniable fact that the number of US public companies has declined considerably from the peak of 20 years ago. The decline, over time, is so significant that it has been cited as warranting policy action.

At EY, we are market leaders in advising entrepreneurs and guiding companies through the initial public offering (IPO) process. In order to inform policy debates, we believe policymakers should consider what lies behind the decline in the total number of US public companies, the attractiveness of US public capital markets today, the growing vibrancy of private capital markets and recent policy actions impacting capital formation.

More than half of the decline in the number of public companies since 1996 can be attributed to the post-dot-com bubble era of business failures and delistings that immediately followed an extraordinary number of IPOs. In more recent years, we find that a surge in private capital and the unique characteristics of many of today's new companies have made it easier to grow outside the public equity market for longer than historically was feasible.

As policymakers debate further actions, we believe it is important to consider objectives and potential consequences. If policymakers' objective is to generate capital formation, economic growth and job creation, it may be less important whether capital formation occurs in public or private capital markets.

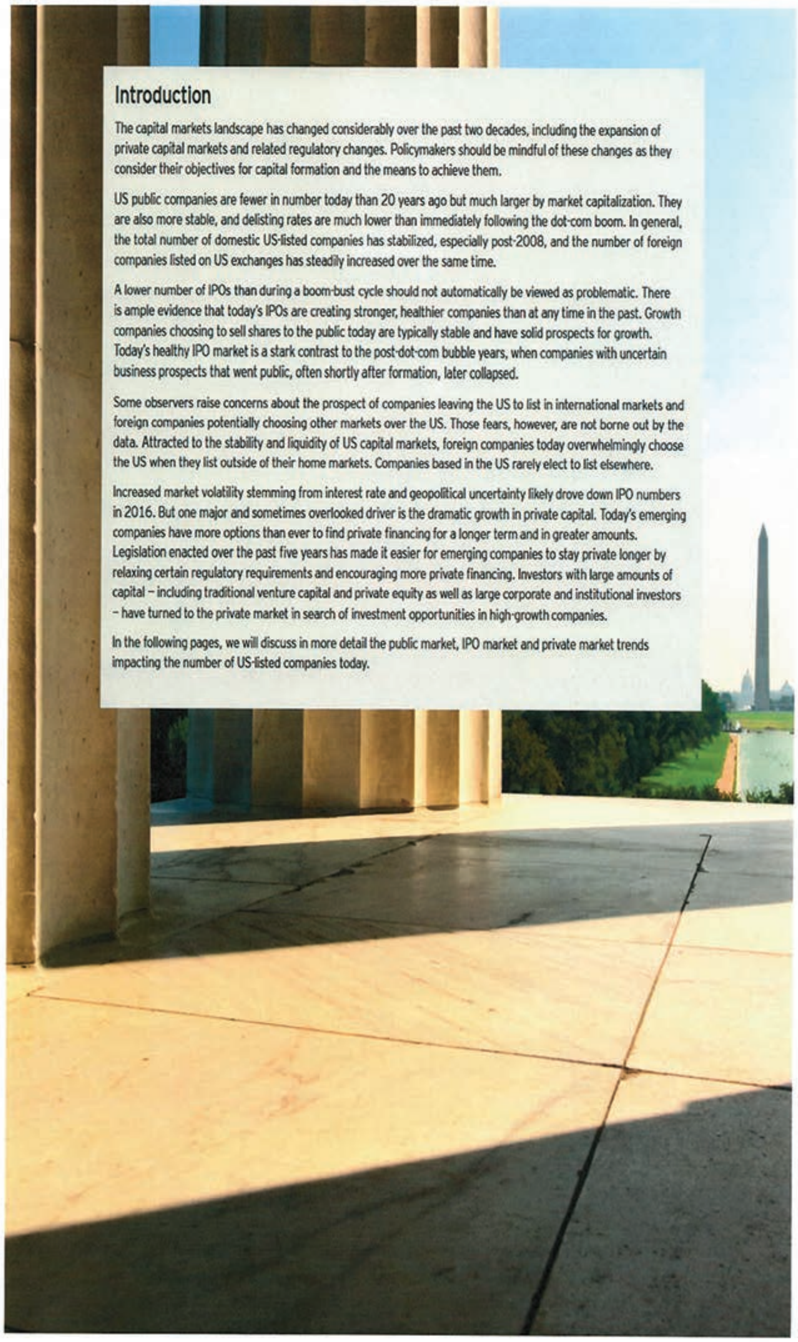
If the objective is to provide retail investors greater access to early-stage high-growth companies, policymakers may face a choice between encouraging a faster pace for IPOs or easing restrictions of private capital market investment opportunities. There are risk trade-offs with either choice – whether due to companies going public too soon, or the relatively lower level of investor protections in the private capital markets.

Policy proposals are presently being debated based on these varied and often competing objectives, regardless of whether they are recognized.

As context, this paper also observes the relative strength and attractiveness of the US public capital markets. It is a mistake to believe that US companies regularly choose to conduct their IPOs outside US public markets. Last year, there were only two. While it is important to consider the "90% rule," whereby 90% of companies across the globe choose to list on an exchange in the country in which the company is domiciled, among the small number of foreign companies that do list on an exchange outside their home country, twice as many choose US markets as those that list in any other jurisdiction.

We hope this paper will help inform and broaden the debate around the historical decline in the number of US public companies.

Les Brorsen
EY Americas Vice Chair, Public Policy



Introduction

The capital markets landscape has changed considerably over the past two decades, including the expansion of private capital markets and related regulatory changes. Policymakers should be mindful of these changes as they consider their objectives for capital formation and the means to achieve them.

US public companies are fewer in number today than 20 years ago but much larger by market capitalization. They are also more stable, and delisting rates are much lower than immediately following the dot-com boom. In general, the total number of domestic US-listed companies has stabilized, especially post-2008, and the number of foreign companies listed on US exchanges has steadily increased over the same time.

A lower number of IPOs than during a boom-bust cycle should not automatically be viewed as problematic. There is ample evidence that today's IPOs are creating stronger, healthier companies than at any time in the past. Growth companies choosing to sell shares to the public today are typically stable and have solid prospects for growth. Today's healthy IPO market is a stark contrast to the post-dot-com bubble years, when companies with uncertain business prospects that went public, often shortly after formation, later collapsed.

Some observers raise concerns about the prospect of companies leaving the US to list in international markets and foreign companies potentially choosing other markets over the US. Those fears, however, are not borne out by the data. Attracted to the stability and liquidity of US capital markets, foreign companies today overwhelmingly choose the US when they list outside of their home markets. Companies based in the US rarely elect to list elsewhere.

Increased market volatility stemming from interest rate and geopolitical uncertainty likely drove down IPO numbers in 2016. But one major and sometimes overlooked driver is the dramatic growth in private capital. Today's emerging companies have more options than ever to find private financing for a longer term and in greater amounts. Legislation enacted over the past five years has made it easier for emerging companies to stay private longer by relaxing certain regulatory requirements and encouraging more private financing. Investors with large amounts of capital – including traditional venture capital and private equity as well as large corporate and institutional investors – have turned to the private market in search of investment opportunities in high-growth companies.

In the following pages, we will discuss in more detail the public market, IPO market and private market trends impacting the number of US-listed companies today.

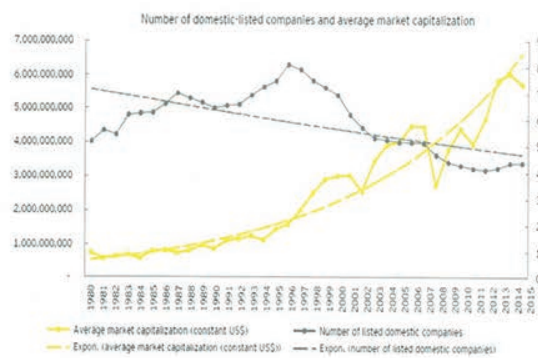
Public market trends: US companies get bigger, more stable

US listings dropped after the dot-com bubble, but the market has largely stabilized, and US public companies today are much larger than in the past.

During the dot-com peak in 1996, US listings hit a record high of more than 8,000 domestically incorporated companies listed on a US stock exchange with an average market capitalization of $1.8b in today's dollars.[1] The number of domestic US-listed public companies decreased precipitously through 2003, with almost 2,800 companies lost because of M&A activity and delistings.[2] By 2003, there were 5,295 domestic US-listed companies.[3] The loss of domestic US-listed companies in 1996-2003 represents 74% of the loss from 1996 to date.4 **(See figures 1 and 2.)**

Figure 1

Change in the number of US public companies



Source: World Bank, excluding investment funds and trusts.

Since the 2008 financial crisis, the total number of domestic US-listed companies has largely stabilized again, ranging between 4,100 and 4,400. During this same period, foreign companies listed on US exchanges have steadily increased in number. **(See figure 2.)**

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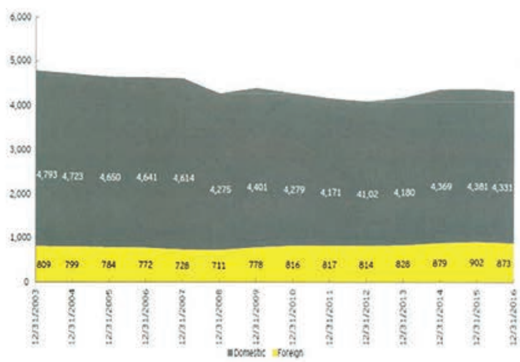
[1] "World Development Indicators," *World Bank website*, databank.worldbank.org, accessed on 7 February 2017 and EY analysis.
[2] "World Development Indicators," *World Bank website*, databank.worldbank.org, accessed on 7 February 2017 and EY analysis.
[3] "World Development Indicators," *World Bank website*, databank.worldbank.org, accessed on 7 February 2017 and EY analysis.
4 "World Development Indicators," *World Bank website*, databank.worldbank.org, accessed on 7 February 2017 and EY analysis.

Figure 2

Domestic and foreign US public companies



Source: World Federation of Exchanges, excluding investment funds and trusts.

Public companies have also grown in size. A typical domestic-listed company today has a higher market capitalization than in the 1990s, a trend that has accelerated in recent years (**See figure 1.**) As of early 2017, the average market capitalization of a US-listed company is $7.3b, and the median is $832m.[5] Also, the largest 1% of US public companies represent 29% of the total market capitalization.[6] About 140 companies now each exceeds $50b in market value, representing more than half of the total US market capitalization.[7]

"The U.S. Listing Gap," a June 2016 academic study using listing data from major exchanges from 1975 to 2012, highlighted some of the delisting trends beginning in the 1990s due to the dot-com bubble. Table 4, Panel A of the study reveals that following the dot-com peak, 2,101 companies were "delisted for cause" over the next seven years (1997-2003), unable to meet the listing standards of their exchange; an average of 300 companies a year. From 2003 to 2012, for-cause delistings fell to fewer than 100 per year.[8]

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[5] *Audit Analytics*, auditanalytics.com accessed on 7 February 2017.
[6] *Audit Analytics*, auditanalytics.com accessed on 7 February 2017.
[7] *Audit Analytics*, auditanalytics.com accessed on 7 February 2017.
[8] "The U.S. Listing Gap," SSRN website, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2605000, accessed 1 April 2017.

IPO trends: keeping sight of the big picture

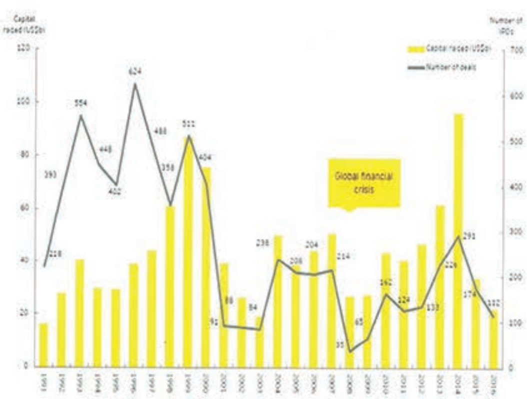
US IPOs are down from their peak in the 1990s, but companies conducting a US IPO today are raising more money than ever before, and more foreign companies executing cross-border listings choose to list in the US, compared with anywhere else in the world.

Public stock offerings of high-profile companies often gain intense public attention, but IPOs are just one of many options for emerging companies to attract investors. While IPO activity has increased after the 2008 recession, the number of public offerings has remained well below its mid-1990s levels. Among other factors, the growth of robust private investment markets and alternative financing methods has extended the private financing stage of the corporate life cycle.

In 2014, the number of US IPOs soared to 291 (**see figure 3**), the highest level since 2000, while the total amount of capital raised through IPOs hit a record of $96b. However, 2015 and 2016 were down years for the IPO market. In 2016, there were only 112 completed IPO deals, raising a total of $21b.

Figure 3

US IPO market 1991-2016



Source: Dealogic and EY analysis
Based on IPO activity on US exchanges, including cross-border deals; excludes special purpose acquisition companies (SPACs) and business development companies (BDCs).

Why the decline in US IPOs in 2016? Market analysts point to a number of contributing factors, including an early 2016 market correction (i.e., increased equity market volatility) stemming from historically high market valuations and uncertainty associated with the US elections, interest rates and global macroeconomic issues. Additionally, the availability of private capital allowed many companies to be more selective with the timing of their IPOs as markets were less stable.

What makes a robust IPO climate?

- Macroeconomic strength
- Market and sector momentum
- Attractive comparable company valuations
- Low volatility
- Strong deal performance

What makes a challenging IPO climate?

- Economic or geopolitical uncertainty
- Market declines
- A risk-averse investor mindset
- Poor recent IPO performance

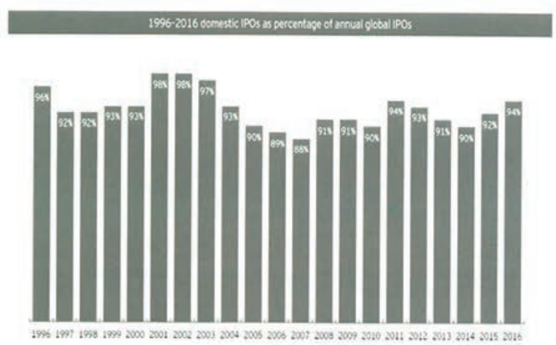
Cross-border listing trends: US exchanges are the destination of choice

We believe it is important to recognize that the US remains the most attractive public equity market in the world. Stock exchanges are located in all regions of the world, and over the long term, more than 90% of IPOs occur on an exchange in the company's home country. **(See figure 4.)** The common reasons for home-country bias include a strong base of customers or a growth strategy that focuses on the home market, a future investor and analyst base located in the home market, a higher comfort level with home-country regulation and compliance standards and cultural identity.

Figure 4

Historically, over 90% of IPOs have listed on their domestic exchanges, and the trend continues

6% of global IPOs in 2016 were cross-border listings



A foreign listing is where the domicile of the primary exchange (or the secondary exchange for dual listings) differs from the listed company domicile. Deals by Chinese companies on Hong Kong Stock Exchange (HKEx) are not considered foreign listings.
Source: Dealogic, Thomson Financial, EY research.

It is also important to note that the profile of US IPOs has changed fundamentally over the past two decades. Although there are fewer offerings, today's US IPOs are fundamentally more stable and are raising more capital. At the 1996 peak, 624 US IPOs created $38b in total deal volume, averaging $61m. From 2012 to 2016, there were fewer than 300 IPOs per year, but average annual IPO proceeds exceeded the 1996 peak.[9] Investors are putting more money into emerging companies, and those companies are likely to be more stable than in the past, as evidenced by the drop in delistings post-2008.[10]

This trend toward IPOs of higher-quality, more sustainable companies is likely to benefit investors. Research provides strong evidence that IPO companies with higher levels of revenue perform better in the long run. Among IPOs completed from 1980 through 2014, issuers with annual revenue over $500m slightly outperformed the market. By contrast, issuers with annual revenue under $100m underperformed the market by an average of more than 27%.[11]

The IPO outlook for 2017-18

After two weak years, signs point toward a rebound in the IPO market. So far in 2017, there has been an uptick in IPO activity, with several high-profile US companies choosing to go public given strong market conditions. That trend may continue with the robust pipeline of companies in venture capital and private equity portfolios seeking their next round of funding.

Issuers have begun pricing IPOs again in April 2017, and volumes are expected to ramp up significantly in the historically busy second-quarter window of May and June. Market and deal performance over the second quarter will influence issuer and investor appetite for the second half of the year and will greatly inform the deal outlook through year-end 2017 and into 2018. Financial sponsors continue to view the IPO market as a useful option on the path to exits, and their portfolio companies will continue to be a key source of IPO deal flow.

There is increased anticipation for listings from a number of start-ups with $1+ billion valuations, also known as unicorns, but most still have the luxury of picking the right timing based on their specific circumstances. As such, there is unlikely to be a long parade of unicorn listings in 2017. However, it would not be surprising to see several high-profile names pursue their much-anticipated IPOs if market conditions remain strong.

For foreign companies choosing to execute a cross-border listing, the US is the favored market. From 2012 through 2016, the US was home to almost twice as many foreign IPOs as its closest competitor, the United Kingdom. During the same time frame, US IPO volume from cross-border listings totaled $66b, more than four times as high as British cross-border IPO volume of around $12b. It's clear that when a company decides to execute a cross-border listing, their market of choice is usually the US.[12] **(See figure 5.)**

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[9] Source: Dealogic, EY research.

[10] Craig Doidge, George Andrew Karolyi and René M. Stulz, "The U.S. Listing Gap," page 41, *Journal of Financial Economics (JFE)*, Forthcoming; *Fisher College of Business Working Paper No. 2015-03-07;* Charles A. Dice Center Working Paper No. 2015-07, 1 June 2016, available at SSRN: https://ssrn.com/abstract=2605000.

[11] Jay R. Ritter, "Initial Public Offerings: Updated Statistics on Long-run Performance," 8 March 2016, https://site.warrington.ufl.edu/ritter/files/2016/03/Initial-Public-Offerings-Updated-Statistics-on-Long-run-Performance-2016-03-08.pdf, accessed 19 April 2017.

[12] Dealogic, Thomson Financial, EY research.

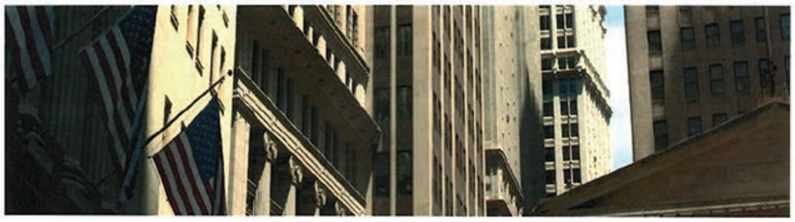
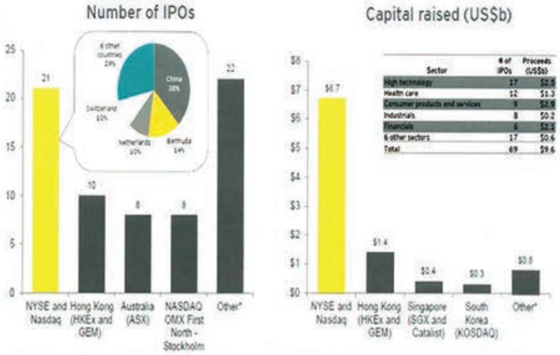


Figure 5

Among the key global IPO markets, the US IPO market attracted more cross-border IPOs in 2016

2016 top stock exchanges for cross-border listings[1]



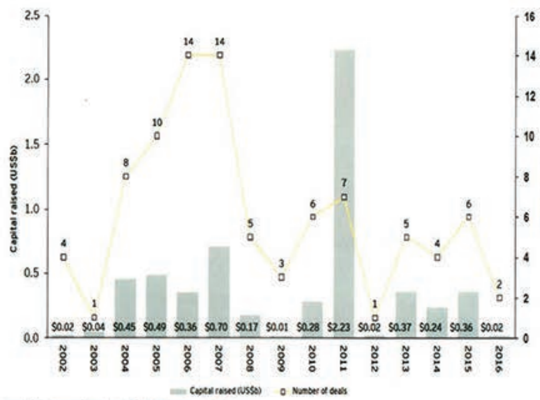
Sector	# of IPOs	Proceeds (US$b)
High technology	17	$2.5
Health care	12	$1.3
Consumer products and services	9	$2.9
Industrials	8	$0.2
Financials	6	$2.1
6 other sectors	17	$0.6
Total	69	$9.6

[1] A foreign listing is where the domicile of the primary exchange (or the secondary exchange for dual listings) differs from the listed company domicile. For dual listings, all funds are allocated to the primary stock exchange. Deals by Chinese companies on HKEx are not considered foreign listings.
* Other cross-border IPOs by number of deals include: London (LSE & AIM) – 7; KOSDAQ – 6; Deutsche Borse – 3; Singapore (SGX & Catalist) – 3; Asia Pacific Exchange (APX) – 1; Bourse des Valeurs d'Abidjan (BRVM) – 1; Euronext (Paris) – 1. Other cross-border IPOs by capital raised (US$m) include: NASDAQ OMX First North – Stockholm – $224; Australia (ASX) – $178; Deutsche Borse – $149; London (LSE & AIM) – $131; Bourse des Valeurs d'Abidjan (BRVM) – $63; Euronext (Paris) – $37; Asia Pacific Exchange (APX) – $3.
Source: Dealogic, EY research

US companies, meanwhile, rarely list elsewhere. **(See figure 6.)** From 2012 to 2016, only 18 US-domiciled companies listed exclusively on foreign exchanges, raising only $1b collectively. In 2016, only two US IPOs listed exclusively on foreign exchanges. Overseas listings also tend to be smaller. Over 15 years, 73% of the 90 US companies that listed abroad raised less than $50m, well below the US non-accelerated filer and smaller reporting company thresholds of $75m in public float.

Figure 6

Very few US companies are listing abroad



Based on IPO activity on non-US exchanges by US-domiciled companies, excluding dual listings
Source: Dealogic

Private market trends: multiple options for growing companies

> *"Why are more companies staying private, and for longer? Because they can."*
>
> **Testimony from Glen Giovannetti, EY Global Biotechnology Leader, before the Securities and Exchange Commission's Advisory Committee on Small and Emerging Companies.[13]**

The private capital market has grown aggressively recently, allowing emerging companies to access more capital without going public.

To accurately measure the health of US capital markets, it is crucial to consider the availability and impact of private capital. Venture capital firms and private equity funds are aggressively financing emerging companies, with the healthy supply of private capital potentially delaying the timing for public offerings. In some cases, emerging companies are being acquired by strategic and financial buyers rather than going public. Venture capital and private equity firms as well as sovereign wealth funds have large amounts of capital to invest. Large companies are establishing venture arms; institutional investors have funds focused on private investing; and both are actively searching for ways to invest sizable amounts of capital.

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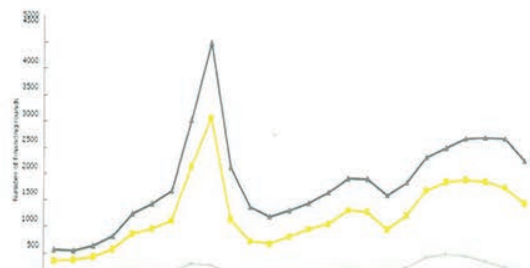
[13] "United States Securities and Exchange Commission Small and Emerging Companies Advisory Committee transcript," *SEC website*, https://www.sec.gov/info/smallbus/acsec/acsec-transcript-021517.pdf, accessed 19 April 2017.

The trend toward private investment has been accelerating. **(See figure 7.)** Venture capital investment in private companies has exploded in recent years. In 2006, $31.2b of venture capital money funded 2,888 private US companies. In 2015, $77.3b went into 4,244 companies.[14] However, we do expect the investment level to revert closer to historical norms as these markets ebb and flow.

Figure 7

There has been an upward trend in VC-backed* company formations



	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Second round	206	175	206	235	376	463	556	887	1414	989	638	507	492	491	592	606	629	640	626	632	642	783	834	932	817
First round	288	290	339	473	682	814	969	1832	2792	1005	646	628	724	867	912	1124	1103	794	978	1257	1370	1439	1507	1497	1299
Seed	74	86	97	112	187	154	158	320	293	146	98	80	105	107	168	218	206	186	272	465	524	494	397	292	187
Total	568	551	642	820	1245	1431	1683	3039	4499	2140	1382	1205	1321	1465	1672	1948	1938	1620	1876	2354	2536	2716	2738	2721	2303

Source: Dow Jones VentureSource.
*Venture capital (VC) includes all investments made by venture capitalists or venture capital-type investors – i.e., those making equity investments in early-stage companies from a fund with multiple limited partners.

Other forms of private financing have grown just as quickly. The difference of just a few years can be dramatic. For example, Facebook raised $2.2b in private funding over seven years (2005 to 2011) ahead of its IPO.[15] Over another seven-year period starting five years later (2010 to 2016), Uber raised more than five times as much capital in equity rounds – nearly $13b from venture capital and private equity firms, sovereign funds and corporations.[16]

For many companies, debt financing has also been an attractive option as companies are able to borrow at or near all-time-low interest rates. Low-cost financing also enables strategic buyers to acquire private companies and smaller public companies. Finally, debt financing allows private companies to avoid diluting shares and adding new investors, thus keeping their shareholder count below the accredited investor limit of 2,000.

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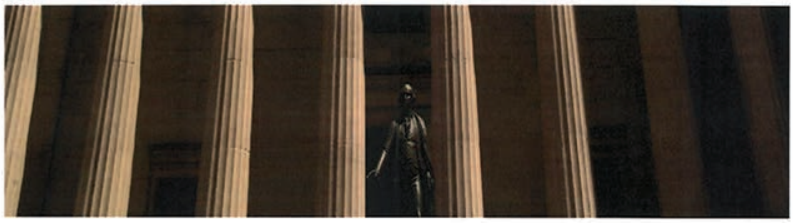
[14] Dow Jones VentureSource
[15] Dow Jones VentureSource, accessed 19 April 2017.
[16] Dow Jones VentureSource, accessed 19 April 2017.



Some of the highest-value unicorn companies that are likely IPO candidates have sought additional financing through debt. While unicorns, start-ups with $1+ billion valuations, do not represent typical VC-backed companies, the top two unicorns as of January 2017 according to The Billion Dollar Startup Club (an interactive feature of *The Wall Street Journal* in conjunction with Dow Jones VentureSource) have taken on a significant amount of debt funding.[17]

Company	Last valuation	Last valuation date	Total equity funding	Total debt funding
Uber	$68.0b	16-Jun	$12.9b	$3.15b[18]
Airbnb	$31.0b	17-Mar	$3.3b	$1.0b[19]

How much do unicorns matter?

US exchanges IPOs	# of unicorn IPOs (% of total IPOs)	Total # of IPOs	Unicorn IPO proceeds – US$m (% of total IPO proceeds)	Total IPO proceeds – US$m
2014	8 (3%)	291	$5,369 (6%)	$96,114
2015	6 (3%)	174	$1,902 (6%)	$33,631
2016	4 (4%)	111	$690 (3%)	$21,419
Total	18 (3%)	576	$7,961 (5%)	$151,164

While a significant amount of media attention is focused on so-called unicorn companies, it is important to remember that unicorns will represent only a small percentage of the population of private, high-growth companies looking to raise capital in the years ahead. The majority of companies that go public will not be unicorns.

Unicorn IPOs are a very small subset of the pool of start-up companies, representing just 3% of IPOs in the last three years since the term "unicorn" was coined in late 2013, and 5% of capital raised. Of the 18 unicorn IPOs, 4 were cross-border US listings of international companies, suggesting that US exchanges are the preferred venue for foreign unicorns to go public.

While being a unicorn brings the benefits of additional cachet, media attention and investor interest, their high valuations must be sustained by accelerating growth and financial performance along with the future liquidity provided from strong public equity markets.

Modern emerging companies are different from in past cycles

The typical profile of today's emerging company is often a better fit with the private market than in previous economic cycles during which companies required heavy capital investments or had more predictable business models.

Some start-up technology companies today are able to build upon 20 years of innovation in technology and take advantage of low-cost cloud-based services rather than having to build their own networks and other infrastructure. Other start-ups are preferring to stay private until they have a more stable business model that will attract more IPO investors.

[17] "The Billion Dollar Startup Club," *The Wall Street Journal* website, https://www.wsj.com/, accessed 19 April 2017.
[18] Dow Jones VentureSource, accessed 19 April 2017.
[19] Dow Jones VentureSource, accessed 19 April 2017.

During a February 2017 meeting of the Securities and Exchange Commission (SEC) Advisory Committee on Small and Emerging Companies, it was observed that this generation of emerging companies and their founders prioritize control and flexibility over wealth creation in a way that encourages private sector financing.[20] Under private owners, disruptive companies are able to take risks, sometimes in unregulated markets, outside of the public company spotlight. While public markets crave predictability, many of today's new companies benefit from the ability to take risks without intense public scrutiny. Under private ownership, employees, founders and early investors are still able to sell shares via private share exchange programs to investors looking for a growth equity stake. Sometimes the company itself will repurchase shares to satisfy shareholder liquidity needs while remaining a privately held entity.

Companies with lower valuations or limited growth prospects have usually been more likely to explore an acquisition, especially if they have technologies or products that are valuable to large firms. However, these acquisitions are occurring in much greater numbers than in prior decades. In 2016, more than 4,800 private companies were acquired, compared with about 1,950 during the IPO peak in 1996.[21] **(See figure 8.)** These trends have been fueled by a robust and sustained level of VC-backed company formations. **(See figure 9.)**

Figure 8

Acquisitions of US private companies remain robust

Source: Dealogic and EY analysis.

[20] "United States Securities and Exchange Commission Small and Emerging Companies Advisory Committee transcript," *SEC website*, https://www.sec.gov/info/smallbus/acsec/acsec-transcript-021517.pdf, accessed 19 April 2017.

[21] Dealogic and EY analysis.

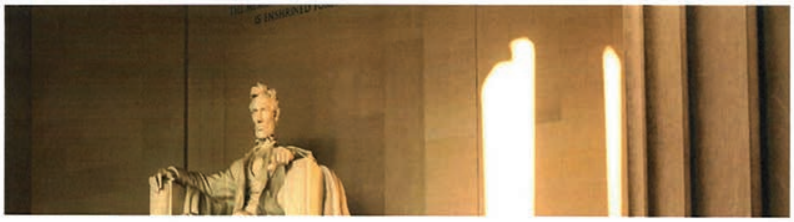


Figure 9

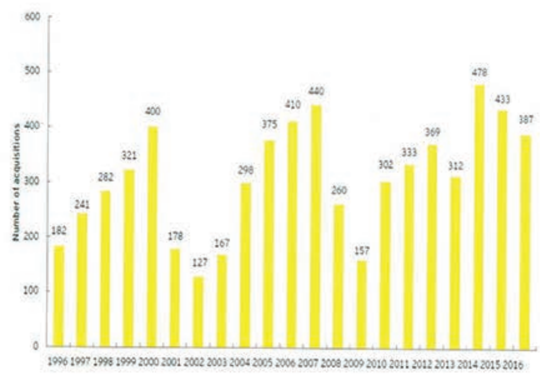
US VC-backed M&A activity remains strong. Valuations drive deal values up in recent years.

Source: Dow Jones VentureSource/EY.

Also, a large number of private companies with valuations in excess of $100m have been acquired in the past few years, illustrating the fact that it remains a viable option for larger companies if an IPO is out of reach. **(See figure 10.)**

Figure 10

Acquisitions of US private companies with values >$100m



Source: Dealogic and EY analysis.

Congress takes action: legislation extends the IPO runway

Emerging companies searching for private financing have benefited from legislation passed in Congress in recent years that has allowed them to access private capital more easily. For example, the Jumpstart Our Business Startups (JOBS) Act of 2012, was intended to promote job creation and economic growth by improving access to the capital markets for emerging companies.

The JOBS Act increased the accredited investor limit for registering with the SEC from 500 to 2,000 and excluded employees receiving exempt equity awards from the investor count.[22] Legislation passed in late 2015 created a safe harbor for secondary private placements that are not registered with the SEC.[23] These changes allow private companies to remain private for longer, as long as their financing needs can be otherwise covered through private debt and private equity capital.

There is continued interest among policymakers to ease regulations on raising private capital. Already in 2017, the House and Senate have both taken up legislation to increase the cap on investors in a qualified venture capital fund from 100 to 250.[24]

[22] 15 U.S Code 78l(g).
[23] 15 U.S Code 77d.
[24] Supporting America's Innovators Act (2017), H.R.1219, S.444.

"[O]ur public capital markets are less attractive to business than in the past. As a result, investment opportunities for Main Street investors are more limited."

Jay Clayton, during his confirmation hearing before the Senate Banking Committee to serve as chair of the Securities and Exchange Commission, 22 March 2017.[25]

The Financial CHOICE Act of 2017, a comprehensive financial services regulatory reform bill authored by House Financial Services Committee Chairman Jeb Hensarling, includes identical language on venture funds.[26] It also adds several other capital formation provisions, including streamlining the Regulation D offering process and authorizing the creation of "venture exchanges."[27,28]

Regulators are also looking at taking steps to spur investment. In a February 2017 speech, Acting SEC Chairman Michael Piwowar called for additional changes to the accredited investor threshold that would allow greater access by retail investors into the private markets, stating that, "In my view, there is a glaring need to move beyond the artificial distinction between 'accredited' and 'non-accredited' investors."[29]

During that same month, SEC Commissioner Kara Stein posed a question regarding additional disclosures and regulation around private market investment, noting, "We also need to understand why more companies are staying private for longer periods of time. Should we apply enhanced disclosure laws to these private companies? Or perhaps they require a unique set of rules."[30]

Crowdfunding is another recently sanctioned private-financing mechanism. Crowdfunding regulations adopted by the SEC in October 2015 allow start-ups and other private businesses to raise small amounts of equity capital (less than $1m annually) from potentially large pools of investors over the internet through an intermediary such as a broker-dealer or funding portal that must register with the SEC. This new platform yielded 163 offerings through the end of 2016.[31]

In addition, a rule known as Regulation A+ (Reg A+) expanded companies' ability to make unregistered public offerings to a maximum of $50m in any 12-month period. Through the end of 2016, there were 97 offerings under Reg A+, raising $239m so far, with a typical company seeking to raise $19m.[32]

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[25] Written testimony submitted to the US Senate Committee on Banking, Housing, and Urban Affairs, Jay Clayton, 23 March 2017, *US Senate Committee on Banking, Housing, and Urban Affairs website*, https://www.banking.senate.gov/public/_cache/files/640c2f54-9c7d-47c2-8dc7-7d4debd6a13d/559D4F50EF7D195B8291094DA7490CA4.clayton-testimony-3-23-17.pdf, accessed 19 April 2017.

[26] The Financial CHOICE Act of 2017, H.R. 10, Section 471.

[27] The Financial CHOICE Act of 2017, H.R. 10, Section 466.

[28] The Financial CHOICE Act of 2017, H.R. 10, Section 456.

[29] "Remarks at the 'SEC Speaks' Conference 2017: Remembering the Forgotten Investor," Acting Chairman Michael S. Piwowar, *SEC website*, https://www.sec.gov/news/speech/piwowar-remembering-the-forgotten-investor.html, accessed 19 April 2017.

[30] "The Markets in 2017: What's at Stake?" Commissioner Kara M. Stein, *SEC website*, https://www.sec.gov/news/speech/stein-sec-speaks-whats-at-stake.html, accessed 19 April 2017.

[31] "U.S. securities-based crowdfunding under Title III of the JOBS Act," *SEC website*, https://www.sec.gov/files/2017-03/RegCF_WhitePaper.pdf, accessed 19 April 2017.

[32] Remarks from the SEC's Division of Economic and Risk Analysis at the 'SEC Speaks' Conference 2017 on 24 and 25 February 2017.

Additional costs to an IPO

An IPO is often the most important capital markets and wealth creation event in a corporate life cycle. Unmatched access to capital at a lower cost is a clear benefit in favor of an IPO, along with corporate branding opportunities and a host of other benefits. However, there are drawbacks to taking a company public that do not exist in the private market. Conducting an IPO results in less control by management and investors and increased accountability to public shareholders. In addition, the company will incur certain one-time costs and must plan for ongoing costs, including increased management and board compensation, advisory and legal fees, liability insurance and regulatory compliance costs. Management decisions and actions in public companies are more heavily scrutinized by investors, analysts and the media. Additionally, management may have different views on the best course for their business than the investment community. Disclosures required of public companies could mean transparency to competitors and the potential for shareholder activism.

Conclusion

In our view, US public capital markets are fundamentally healthy and remain the preferred choice for US and many foreign companies that seek to go public. The dynamics in the private capital market have changed significantly, at least temporarily, and allow companies to grow larger and stay private longer. The amount of private investment has grown immensely and takes many forms, including venture capital, private equity and debt financing. Companies that make it to a public offering in recent years have tended to be more mature and have solid business prospects, in contrast to the prior boom-bust cycles.

As policymakers respond to concerns about the decline in public company numbers, the implications to investors and companies could be significant and raise important questions:

- *What should be the guiding objective of public policy regarding the public and private capital markets?*
- *Is the ultimate goal to generate capital formation in the US, regardless of whether it is in the public or private market?*
- *Is there a desire for more companies to go public sooner, if only to afford retail investors greater access to high-growth companies earlier in the corporate life cycle?*
- *Should regulations on private capital market investment be eased to afford more investors greater access, even though doing so would serve to further companies' ability to grow bigger and stay private longer?*
- *Should private capital market activity be regulated differently if restrictions on investor participation are changed?*

These are only some of the questions we believe warrant consideration as policymakers consider proposals that could have significant implications for investors, companies and the economy as a whole.

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NASAA

June 28, 2018

The Honorable Mike Crapo
Chairman
Senate Committee on Banking, Housing
& Urban Affairs
538 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Senate Committee on Banking, Housing
& Urban Affairs
538 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Legislation Considered by the Committee on June 26, 2018 and June 28, 2018

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the North American Securities Administrators Association (NASAA),[1] I am writing to provide NASAA's perspective on certain legislative proposals that have been the subject of hearings by the Committee on Banking, Housing and Urban Affairs during the week of June 25, 2018.

1. The "Cybersecurity Disclosure Act" (S. 536)

The "Cybersecurity Disclosure Act" would amend the Securities Exchange Act of 1934 to require that publicly traded companies disclose in their annual filings with the U.S. Securities and Exchange Commission (SEC) whether any member of their governing body, such as their board of directors or general partner, possesses expertise or experience in cybersecurity. The bill does not impose any requirements on issuers beyond disclosure of the specified information.

Incentivizing publicly traded companies to consider whether they have adequate cybersecurity expertise in their governing body is an appropriate step given that cyberattacks on U.S. companies continue to increase in both frequency and sophistication. Cybersecurity risk and preparedness can have major implications for businesses and their investors.[2] Further, investors, issuers, and consumers stand to be well-served by policies that encourage companies to consider cybersecurity risks proactively, as opposed to after a data breach or other intrusion has occurred, when the harm may be

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1 The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

2 In 2017, I authored an op-ed highlighting the growing concern over the number of cyberattacks perpetrated against companies and the efforts state securities regulators are taking to assist mid-sized investment advisers to improve their cybersecurity practices. (See: Borg, Joseph P. "Everyone has a Role in Protecting against Cyberattacks". September 5, 2017. Available at www.americanbar.org/content/dam/aba/administrative/business_law/newsletters/CL680000/full-issue-201709.authcheckdam.pdf).

irreversible. In fact, we note that since the bill's introduction in 2017, the SEC has issued guidance that compliments and supports the legislation's premise.[3]

NASAA is pleased to support S. 536.

2. The "Fair Investment Opportunities for Professional Experts Act" (S. 2756)

S. 2756, the "Fair Investment Opportunities for Professional Experts Act", would amend the Securities Act of 1933 to add specified, inflation-adjusted income and net-worth standards to the "accredited investor" definition. In addition, the bill extends "accredited investor" status to new categories of natural persons who would qualify as "accredited" irrespective of income or net-worth.

NASAA is not wholly opposed to efforts to modernize the accredited investor standard, including in a manner that would increase the size of this marketplace, as is envisioned by S. 2756. Further, NASAA appreciates the steps that the sponsors of S. 2756 have taken to improve the legislation relative to similarly entitled legislation previously passed by the House of Representatives, including in consultation with NASAA.[4] Nevertheless, state regulators have a very large stake in any legislative changes that would affect the private securities markets.[5] We strongly believe that any legislation that effects a further expansion of private securities markets must also take steps to improve the oversight of these markets by providing regulators with better tools to address fraud and misconduct in these markets.[6]

Further, NASAA respectfully reminds the Committee that policies that implicate private securities markets cannot be judged in isolation. Over the past two decades, there has been a dramatic shift in how companies raise capital. Private securities once comprised just a fraction of the overall marketplace, but today they serve as a major source of capital for certain businesses, exceeding the public markets.[7] The unprecedented growth in private markets, and the decline in initial public

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[3] "U.S. SEC Calls for 'Clearer' Cyber Risk Disclosure from Companies". *Reuters*. February 21, 2018. *See:* https://www.reuters.com/article/us-usa-sec-cyber/u-s-sec-calls-for-clearer-cyber-risk-disclosure-from-companies-idUSKCN1G52FK.

[4] Section 2(b) of S. 2756 imposes guidelines that the SEC must follow in issuing a rule to determine whether a natural person may qualify as an accredited investor by virtue of education, job, or professional experience. No similar requirements are included in H.R.1585, the "Fair Investment Opportunities for Professional Experts Act". We also note that, whereas H.R. 1585 would adjust the income and net-worth standards to account for inflation every five years, S. 2756 would adjust them every three years.

[5] State securities regulators, pursuant to their antifraud authority, are the de-facto primary regulators of offerings conducted under Regulation D, Rule 506. State regulators frequently receive complaints from those who are victimized in offerings conducted under Rule 506, and expend considerable resources policing this marketplace.

[6] Specifically, S. 2756 should be improved by incorporating modest changes to Rule 506 and Form D that will enhance the ability of the SEC and NASAA members to protect investors while minimizing the burdens to the small businesses who utilize the rule to raise capital. Such changes were proposed by the SEC in 2013, but have not yet been adopted. (*For additional information, see: https://www.sec.gov/comments/4-692/4692-34.pdf*). NASAA has also offered suggestions for how to revise the current accredited investor definition to more accurately measure investor sophistication, and to limit the exposure of less sophisticated investors to the risks of the private marketplace. (*For additional information, see: http://www.nasaa.org/wp-content/uploads/2013/10/NASAA-Letter-to-House-Leadership-Re-HR-1585-11-1-17.pdf*).

[7] See: SEC Division of Economic and Risk Analysis, Access to Capital and Market Liquidity (Aug. 8, 2017), available at https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf. See also: Scott W. Bauguess, Deputy Director, SEC Division of Economic Risk and Analysis, Private Securities Offerings post-JOBS Act. Presentation to

offerings (IPOs), can be attributed in part to Congress. Congress has made it easier for companies to raise capital in private markets and that is one of the main reasons that more companies are staying private for longer instead of pursuing IPOs.[8] Given Congress's ongoing, bipartisan interest in increasing the number of IPOs – efforts which were discussed by the Committee at a hearing earlier this week[9] – Congress should be thoughtful in taking any steps that would further expand the private markets to the potential detriment of public markets.

3. The "Helping Angels Lead Our Startups Act" (S. 588)

The "Helping Angels Lead Our Startups Act", or "HALOS Act," would direct the SEC to amend Rule 506 of Regulation D to specify that prohibitions on general solicitation and general advertising in Rule 506 offerings do not apply to sales events (also called "demo days", "venture fairs", or "pitch days") that are sponsored by a governmental entity, a college or university, a nonprofit organization, an angel investor group, a trade association, a venture forum, or a venture capital association. The bill would also limit the amount and type of information that can be communicated prior to, and at, such events.

Given that Congress has already acted to repeal the prohibition on general solicitation in certain private securities offerings under SEC Rule 506(c), it is not clear why Congress would now require the SEC to relax rules governing the use of solicitation to non-accredited investors under Rule 506(b).[10] However, in the event that Congress determines such action is appropriate, there are steps the Senate can and should take to improve the legislation prior to its becoming law.

As presently constituted, the types of entities that would be eligible to sponsor an event under S. 588 is exceptionally broad. Congress should consider whether these criteria should be made more tailored thereby narrowing the number of entities eligible to sponsor such events.[11] Further, Congress

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Accounting Standards Executive Committee (Feb. 25, 2016), available at https://www.sec.gov/info/smallbus/acsec/private- securities-offerings-post-jobs-act-bauguess-022516.pdf.

[8] As Healthy Markets Association Executive Director Tyler Gellasch recently testified to a subcommittee of the House Financial Services Committee, "It's not a great mystery why in the last few years the trend has developed whereby there are more private offerings in the U.S. today than public ones. In the past, the law and SEC rules simply didn't permit all these private offerings. Over the past two decades, however, Congress and the SEC have spent years constructing ad hoc exemptions and exceptions designed to allow firms, their executives, and their early investors to sell securities without incurring the costs or burdens typically associated with public offerings. While some of these exemptions and exceptions may have been well-intended, the undeniable result has been that they have grown so dramatically that they have undermined the public markets." (See: Testimony of Tyler Gellasch before the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment (May 23, 2018).

[9] *See: Legislative Proposals to Increase Access to Capital*, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 115th Cong. (Jun. 26, 2018).

[10] In Title II of the JOBS Act of 2012, Congress expanded companies' ability to attract buyers to their private offerings by permitting general solicitation and advertising. This exemption, codified under SEC Rule 506(c), can be claimed provided that issuers only sell to accredited investors and that they take "reasonable steps" to verify that the investors are accredited. The HALOS Act would go further and exempt demo days from the prohibition on general solicitation and advertising, thereby allowing companies to generally solicit and advertise and still be able to use 506(b), which unlike Rule 506 (c), does not require issuers to take reasonable steps to determine whether investors are accredited.

[11] As University of University of Mississippi Law School Professor Mercer Bullard testified to the Committee this week, S. 588 "will allow virtually any type of public entity to advertise and host an event that can be attended by any person for the purpose of any issuer pitching a securities offering." *See:* https://www.banking.senate.gov/imo/media/doc/Bullard%20Testimony%206-26-18.pdf

should require the filing of Form D with the SEC and the relevant state regulator prior to the event.[12] The information included in Form D would be particularly valuable to state regulators who will be tasked with ensuring that "demo days" and similar events sponsored in their jurisdictions are legitimate and compliant with the law. Finally, Congress should clarify that attendance at an event does not in itself establish a pre-existing relationship for purposes of Rule 506(b).

4. The "Compensation for Cheated Investors Act" (S. 2499)

S. 2499, the "Compensation for Cheated Investors Act", would direct the Financial Industry Regulatory Authority (FINRA) to establish a fund to provide investors with the full value of unpaid arbitration awards issued against brokerage firms or brokers regulated by FINRA. The bill would also require FINRA to provide enhanced public disclosure of information pertaining to the total number of arbitration awards issued in favor of investors against brokerage firms or brokers regulated by FINRA.

NASAA welcomes the introduction of S. 2499, and wholeheartedly supports the intent behind the legislation, which is to ensure that wronged investors are not literally left holding the bag when it comes to the payment of arbitration awards issued against broker-dealer firms and their representatives. Unpaid arbitration awards remain an unresolved and well-documented investor protection concern. In failing to pay arbitration awards, broker-dealers fail to comply with their legal, regulatory and ethical obligations. NASAA has been a longstanding proponent of measures to address this problem.[13] We look forward to working with Congress and other stakeholders to finding a solution so that no investor awards or settlements go unpaid.

5. The "Expanding Access to Capital for Rural Job Creators Act" (S. 2953)

S. 2953, the "Expanding Access to Capital for Rural Job Creators Act", would amend the Securities Exchange Act of 1934 to add "rural-area small businesses" to the scope of small businesses with unique challenges and issues from which the SEC Advocate for Small Business Capital Formation is required to (1) identify problems with securing access to capital; and (2) issue an annual report containing a summary of the most serious issues encountered by such businesses and their investors.

As the closest regulators to the investing public, NASAA's members regularly work with and assist local businesses seeking investment capital. On the basis of this experience, we strongly agree with legislation's premise – which is that rural communities and the small businesses located in these communities can face unique barriers to accessing capital.

NASAA is pleased to support S. 2953.

Thank you for your consideration of NASAA's views. If I may be of further assistance, please don't hesitate to contact me or Michael Canning, NASAA's Director of Policy and Government Affairs, at (202) 737-0900.

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[12] NASAA has repeatedly urged Congress to require the filing of Form D prior to sale or general solicitation of securities offerings exempt from registration under Regulation D. Under the current rules, Form D need not be filed until 15 days after the first sale, so an issuer can advertise for investors without filing the form. The lack of any pre-solicitation filing makes it impossible for state enforcement personnel to easily determine whether an offering is being conducted in accordance with the securities laws.

[13] *See, e.g.*, Letter from NASAA President Joseph Borg to March E. Asquith regarding FINRA Regulatory Notice 17-33 (Dec. 20, 2017).

Sincerely,

Joseph P. Borg
NASAA President and Alabama Securities Commission Director

Vanguard

What's behind the falling number of public companies?

Vanguard Research Note | November 2017

- The number of publicly listed U.S. companies has fallen by about 50 percent in the last 20 years. But focusing solely on this decreasing number masks some important trends.
- A closer look at these market and regulatory trends reveals that micro-cap companies account for most of the decline.
- We find that the shrinking number of public companies has not materially changed the concentration and diversification of the investable U.S. market.

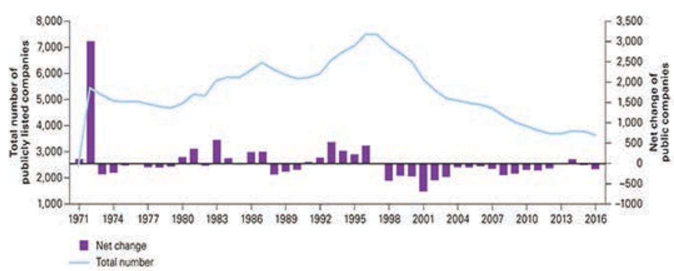
In 1996, the number of publicly listed U.S. companies exceeded 7,000. By the end of 2016, that number had dropped below 3,800.[1] There is conjecture that burdensome regulations impede companies from going public and obtaining funding.[2] However, the declining number alone doesn't tell the whole story.

In this research note, we show that the decline appears to be largely limited to micro-cap companies and that the focus on the number of companies—rather than market capitalization—does not fully measure the equity market's health. Our research suggests that despite the decrease, the concentration and diversification in the investable U.S. equity market has not materially changed. However, while our research reviews potential causes of the decrease, it does not intend to draw conclusions regarding the economic effects of the decrease.

To what extent is the number really shrinking?

Although it is true that the number of public companies has been falling since 1996, the headline number, if accepted at face value, is misleading. **Figure 1** shows that the severity of the trend depends on the time horizon of the analysis. When viewed relative to 1996, it appears that the number of publicly listed companies has fallen by more than half.[3] However, the number of public companies in 1996 could very well be viewed as a

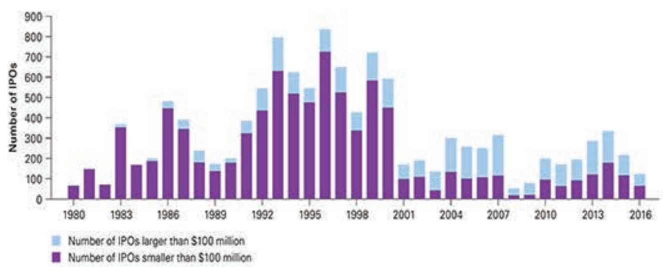
Figure 1. The existence of a trend depends on the time horizon



Notes: Publicly listed companies include those traded on NYSE, AMEX, and NASDAQ. Pink sheet stocks are traded over the counter and, thus, are not included in the chart.
Source: Vanguard calculations based on data from CRSP.

1 Center for Research in Security Prices (CRSP).
2 See Piwowar (2017).
3 Publicly listed companies are those on file with CRSP and traded on NYSE, AMEX, and NASDAQ; they exclude American depositary receipts and closed-end funds.

Figure 2. Larger IPOs have remained relatively stable



Note: Setting the threshold at $50 million yields a similar trend.
Source: Vanguard calculations based on data from Bloomberg.

high point, rather than a normal amount, because of the economic boom in the 1990s leading up to the tech bubble. When viewed relative to 1972, the decline shrinks to one-third. Moreover, the spike in the number of publicly listed companies in 1972 occurred because NASDAQ went public and the 3,000-plus companies that previously traded over the counter became publicly listed.

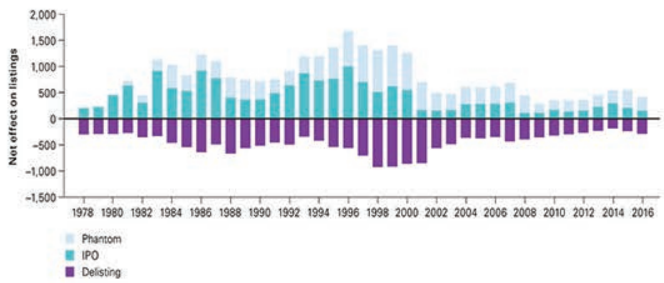
The blame for the decline is often focused on the drop in the number of initial public offerings (IPOs).[4] But this largely ignores analysis of additional characteristics of those companies, such as their size. **Figure 2** shows the number of IPOs according to company size. Smaller firms, defined as those with gross IPO proceeds under $100 million—which essentially makes them micro-cap companies—fell precipitously following the tech bubble.[5]

The disappearance of small- and micro-firm IPOs was the main reason the total number of stocks declined between 1996 and 2016, consistent with what Ritter (2011) has noted. Meanwhile, larger firms continue to keep a healthy pace of IPOs. Since 2003, there have been more large-firm IPOs than smaller ones in all but one year.

It appears that companies are choosing to be acquired by larger public companies rather than go public themselves. **Figure 3**, on page 3, shows the change in the number of publicly listed companies by accounting for those companies that were acquired in lieu of going public. An IPO is considered a net addition to public equity (positive bars), while a delisting from a public exchange is considered a net subtraction (negative bar). Measuring just these two actions shows that the net

4 See VanderMey (2017) and Brown et al. (2017).
5 For context, the bottom of the range of the Russell 2000 Index for the 2016 reconstitution was $132.9 million and for the 2017 reconstitution was $143.6 million, according to FTSE Russell (2017).

Figure 3. Private companies often "go public" as part of a larger company



Notes: "Phantom" means private companies that are bought by public companies. Reasons for delisting include voluntary (companies choose to delist), cause (companies are forced to delist), and merger (companies are delisted because of acquisition).

Sources: Vanguard calculations based on data from Thomson Reuters and CRSP. Data on public companies buying private companies are from Thomson Reuters' M&A database.

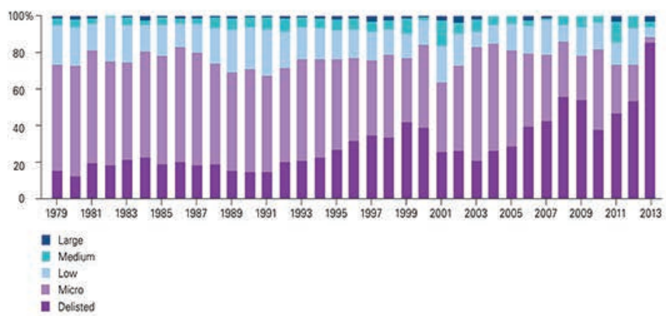
difference in the number of publicly listed companies is generally negative, confirming a trend of a decline. However, if we include the number of private companies that were acquired by public ones—what we call "phantom" companies—the number of net additions becomes positive. In other words, focusing only on the number of public companies eliminates a group of private companies—about 500 each year—that essentially join the public market as part of a bigger company through merger and/or acquisition.

Even after going public via an IPO, most companies remain small relative to other publicly listed companies. **Figure 4a**, on page 4, shows that only a very small percentage of companies grow to become small-, mid-, or large-cap. The overwhelming majority of companies either remain micro-cap or delist, and it appears that of those two outcomes, a growing portion was delisted.

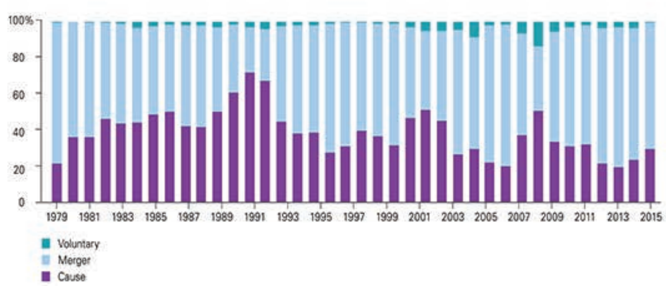
However, a firm's being delisted does not necessarily mean it is no longer represented in the public market. **Figure 4b**, on page 4, indicates that mergers are the cause of a growing proportion of delisted firms. Even though these companies cease to exist from a "count" perspective, they continue to exist from a "company value" perspective because their business enterprise exists as part of another public company.

Figure 4. The smallest companies stay that way, while those that delist usually merge

a. Stocks' size group three years after their IPO



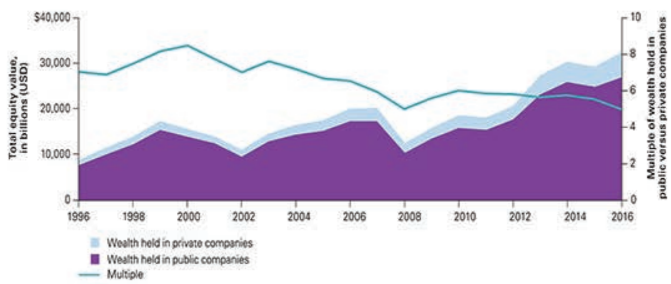
b. Stocks' reasons for delisting



Notes: Large, mid, low, and micro are defined by CRSP. The first and second deciles are defined as large-cap; the third, fourth, and fifth are defined as mid-cap; the sixth, seventh, and eighth are defined as low-cap (i.e., small-cap); and the ninth and tenth are defined as micro-cap. Only securities that had portfolio assignments at year-end were used. Voluntary means companies choose to delist, merger means companies are delisted because of acquisition, and cause means companies are forced to delist.

Source: Vanguard calculations based on data from CRSP.

Figure 5. Size of private equity has been growing relative to public equity



Source: Vanguard calculations based on Federal Reserve Board Flow of Funds.

Weighing the effect of regulatory and structural changes

Reasons for the decrease in IPOs and the number of publicly listed companies tend to focus on the compliance and regulation costs of being public. This appears to have some validity. Evidence suggests that even though changes to market structure and the regulatory landscape have led to a diminishing benefit of going public, this has coincided with an increasing benefit of staying private.[6]

Consequently, **Figure 5** shows the multiple of public-to-private equity value has been on a downward trend. However, the overall value of public equity markets has continued to grow—just not at the same pace as that of private equity markets. Put another way, public market equity isn't suffering in absolute terms; rather, it's lagging in relative terms.[7]

Implications for investors

Despite the drop in the number of publicly listed companies, there appear to be few, if any, implications for investors. The investable U.S. equity market—the large-, mid-, and small-cap stocks that reflect investors' investable opportunity set—has remained a relatively constant proportion of the total U.S. equity market, and it has also maintained a consistent level of concentration among its constituents. These proportion and concentration effects are measured in terms of a company's *value*, and they are sometimes overlooked by a focus on the shrinking *number* of public companies.

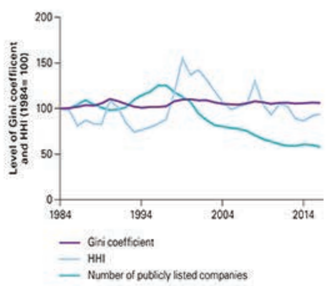
6 See the Appendix and, notably, Figure A-I for a more detailed discussion.

7 These structural and regulatory changes might also explain why companies stay private for longer periods and why the size of private equity markets has grown by more than that of public equity markets. See the Appendix and, notably, Figure A-II for a more detailed discussion.

Figure 6a, on page 6, shows that the total number of micro-caps has been falling. However, **Figure 6b**, on page 6, shows that micro-caps' proportion of overall market capitalization has stayed relatively stable, at around 1.5%. It is important to note that these smallest firms are not considered investable for most mutual funds and are not included in many indexes because of their illiquidity and the regulatory constraints on the amount of ownership that may be acquired. In other words, the shrinking number of publicly listed companies consists almost entirely of those securities that would not have been invested in by active and passive funds anyway.

It does not appear that the investable market has become more concentrated as a result of a smaller number of public companies, either. We adopted two concepts from social and industrial economics: the Gini coefficient[8] and the Herfindahl-Hirschman Index (HHI).[9] Applied to our analysis of equity market concentration, the Gini coefficient and HHI would become larger if the market were more concentrated. **Figure 7** plots the year-on-year changes of the Gini coefficient and the HHI, as well as the change in the number of public companies. Despite the fact that the number of public companies has been declining, neither the Gini coefficient nor the HHI shows a trend of higher level of market inequality or concentration.

Figure 7. Degree of concentration of public equities in the investable market has no noticeable trend



Notes: FactSet started reporting the weight of companies in the Russell 3000 Index in 1984. The chart shows the levels of Gini coefficient, HHI, and the number of publicly listed companies, all of which were indexed to a value of 100 in 1984.
Source: Vanguard calculations based on data from FactSet.

Conclusion

In this research note, we explored some causes of—and implications for—investors related to the shrinking number of public companies. Our analysis suggests that the falloff in publicly listed companies has been a micro-cap phenomenon and that the focus on the shrinking number of public companies ignores the overall market capitalization of the public equity market.

We believe the headline number is shrinking in part because of the increasing benefits—from a company's perspective—of remaining private. Despite the trend, however, we do not believe that the public market has become less investable or more concentrated.

8 Gini coefficient is a statistical measure of the degree of variation represented in a set of values, used especially in analyzing income inequality. See Cingano (2014) for the analyses on Gini coefficient and income inequality.
9 HHI is a measure of market concentration within an industry. See Rhoades (1993) for a description of HHI.

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Appendix

Figure A-I. Major structural and regulatory changes of public and private equity markets

Public market regulation and structural events	
1996	Introduction and growth of online brokerage accounts might have reduced the incentive for small-cap market makers.
2000	The SEC's fair disclosure mandate might have caused a deterioration of research coverage for small companies.
2001	Decimalization might have reduced the incentive for small-cap market makers and research coverage.
2002	The Sarbanes-Oxley Act (SOX) might have raised compliance costs for issuers.
2003	The Global Settlement separated research and investment banking, possibly reducing incentives to provide research coverage for small companies.
2005	The SEC's Regulation National Market System provided investors with equal access to information, contributing to increased fragmentation and "dark" pools of liquidity.
Private market deregulation	
1982	SEC Regulation D provided several safe harbors from registration.
1990	SEC Rule 144A allowed resale of private securities without restriction to qualified institutional buyers.
1996	A change to Section 3(c)7 of the Investment Company Act of 1940 effectively removed the 100-investor cap for private investment funds, although investors are still subject to status as a "qualified purchaser."
2012	The Jumpstart Our Business Startups (JOBS) Act raised the shareholder ceiling of private companies from 500 to 2,000.
2015	NASDAQ acquired SecondMarket to facilitate the exchange of shares for private companies.

Source: Mauboussin, Callahan, and Majd (2017) and De Fontenay (2017).

Earlier analyses into the shrinking number of public companies largely focused on the growing regulatory burden that lessened the incentive for companies to go public. For example, the Sarbanes-Oxley Act (SOX) in 2002 is commonly blamed for raising compliance costs for issuers.[10] Other regulations, such as the 2003 Global Settlement, which settled allegations of conflicts of interest between investment banking and securities research at brokerage firms, reduced research coverage for small firms and might have dampened market-making.[11]

However, more recent research has noted that the decline in the number of publicly listed companies predates these regulations and has shifted attention to changes that occurred before SOX.[12] For example, Weild and Kim (2009) contended that the collective changes in regulation and market structure led to a "perfect storm," reducing the incentive to go public. Additionally, the shrinking number of public companies seems to take place only in the United States; the numbers are trending higher in many other major countries, although their regulations on the public market have been tightening.[13]

It is possible that the challenge for private companies isn't necessarily that they face higher costs as public companies but that they enjoy relatively more benefits from remaining private. Loosening regulation on the private market has allowed private companies to garner benefits usually enjoyed by public companies. For example, Rule 504 of Regulation D adopted by the SEC in 1982 provided an exemption for certain types of investors to invest in the private market. Since then, however, the exemption has allowed a growing number of individual investors to participate in the private market.[14]

10 Zhang (2007) found negative cumulative abnormal returns following the passage of SOX; Engel, Hayes, and Wang (2007) observed an increase in decisions to go private after SOX.

11 See Mauboussin, Callahan, and Majd (2017).

12 Mauboussin, Callahan, and Majd (2017) and Doidge, Karolyi, and Stulz (2017) noted that half of what can be referred to as the "listing gap" occurred before SOX became law.

13 See World Bank (2017) for data on total listed domestic companies in each nation since 1975; Doidge, Karolyi, and Stulz (2017) observed a similar pattern, although their data were up until 2013.

14 See De Fontenay (2017).

Liquidity in private securities has increased in part because the adoption of SEC Rule 144A facilitated the resale of private securities, and the emergence of exchanges catering to private company investors allows investors to trade their shares.[15] Also, the JOBS Act increased the cap—from 500 to 2,000—on the number of shareholders that requires companies to go public, thus allowing private companies to broaden their investor base. Finally, increasing the financial disclosure requirement from public companies creates a positive externality to their private counterparts.[16]

As a result, the "time to exit" for private equity has been increasing since 2006 across several exit strategies, as shown in **Figure A-II**. For example, in 2006, private equity waited only three years before realizing its exit strategy through IPO. By 2015, that wait was seven years. As a result, companies that go public are in a much more mature stage. Exits via secondary buyout and corporate acquisition have followed a similar trend.

Realizing the pressing need to limit the costs of going public, the SEC recently extended to larger companies a confidentiality exemption that previously had been granted only to small companies and start-ups. The exemption allows larger firms to keep their financing intentions, business strategy, and operating performance private while the SEC reviews their offering prospectus.[17] This might be a step in the right direction, but reversing a tide three decades in the making still poses a challenge.

Figure A-II. It has been taking longer for companies to go public

Notes: The oldest data available from open-source PitchBook data are from 2006. The 2016 data had not been published when this paper was prepared. The chart represents the three options for private equity to exit: IPO, corporate acquisition, and secondary buyout.

Source: Vanguard calculations based on data from PitchBook.

15 See Bauguess, Gullapalli, and Ivanov (2015).

16 See Oesterle (1999) on how the information disclosed by publicly listed companies becomes a positive externality for private firms in a similar industry.

17 See Bullock (2017).

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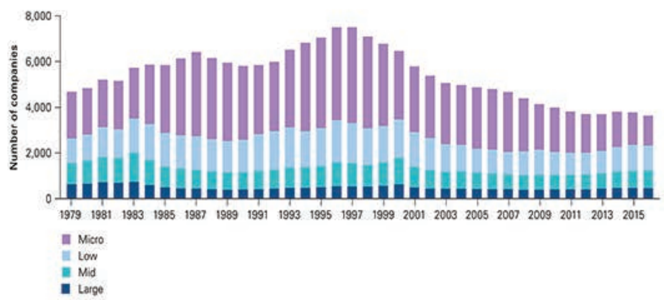
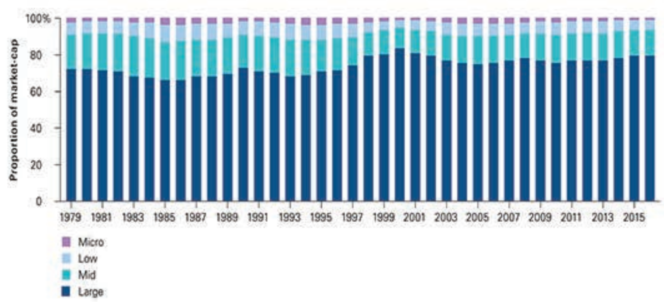
Figure 6. For micro-caps, number is not the same as proportion

a. Number of public companies grouped by size



b. Market-cap proportion of companies grouped by size



Notes: Large, mid, low, and micro are defined by CRSP. The first and second deciles are defined as large-cap; the third, fourth, and fifth are defined as mid-cap; the sixth, seventh, and eighth are defined as low-cap (i.e., small-cap); and the ninth and tenth are defined as micro-cap. Only securities that had portfolio assignments at year-end were used.

Source: Vanguard calculations based on data from CRSP.

AFR Americans for Financial Reform

AFR Statement

June 26, 2018

The Senate Committee on Banking, Housing, and Urban Affairs meets today to conduct hearings on a set of bills ostensibly designed to increase access to capital. Several of these bills are part of a dangerous agenda to rollback securities markets regulations. The deregulation of private capital markets contemplated in these bills would disproportionally affect small, retail investors vis-à-vis large investors and would undermine the effective regulations and investor protections that are fundamental principles of stable and enlarging U.S. public capital markets.

There is no evidence supporting the premise that undercutting compliance with enacted regulations would magically increase the number of initial public offerings (IPOs). In fact, this approach—represented by the passage of the JOBS Act in 2012—has proven ineffective and even counterproductive. Instead of encouraging public markets, Congress' deregulatory spree of private capital markets further undermines public offerings by incentivizing companies to stay private and reap the advantages of expanded exemptions and reduced compliance relative to IPOs. A number of bills in these hearings would double-down on this failed approach by reducing disclosure requirements that are integral to maintain investor confidence and stable capital markets.

Another bill, S 1117, the "Consumer Choice and Capital Markets Protection Act", would roll back post-crisis systemic risk protections related to money market funds.

A more extensive, detailed discussion of the securities markets implications of today's hearing can be found in the testimony of Mercer E. Bullard, Professor of Law at the University of Mississippi School of Law, at: https://bit.ly/2I9JNIP. In addition, Americans for Financial Reform has previously written opposition letters to three of the bills under consideration today when they were advanced in the House. These letters are quoted below.

- S. 588, the "Helping Angels Lead Our Startups (HALOS) Act"
  Related House bill: H.R. 79

  Previous AFR Statement: The "HALOS Act," would permit issuers of unregistered securities to be exempted from safeguards regarding general solicitations so long as such solicitations were made at an 'event' sponsored by any of a wide range of non-profit or educational organizations, investor associations, or trade associations.

  SEC registration requirements are designed to protect investors by providing investors with verified, reliable financial information concerning the securities in which they invest. The JOBS Act made it possible to do broad-based general solicitation of the public for the sale of riskier unregistered securities. But it also required that companies do a good-faith verification that investors were in fact accredited investors who met a range of qualifications indicating they could afford the increased risk of loss associated with investing in unregistered securities. This requirement is an important investor protection.

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The HALOS Act would eliminate this investor protection for a very wide range of types of issuer events, events that could easily be used to solicit investment from the broader public, including many who are not accredited investors. This exemption is overly broad and would likely lead to losses for investors who are not prepared to take the significant risks associated with purchases of unregistered securities.

- S. 1117, the "Consumer Financial Choice and Capital Markets Protection Act of 2017"
  Related House bill: H.R. 2319

  Previous AFR Statement: H.R. 2319 would reverse key 2014 reforms to rules governing Money Market Funds (MMFs). During the 2008 crisis, declines in the value of MMFs that were over-invested in risky bank debt eventually led to a multi-hundred billion-dollar run on the entire sector of prime MMFs. Due to the threat to financial stability and the broader economy, the Federal government intervened and bailed out the entire MMF sector by publicly guaranteeing its assets. This stopped the run, but exposed taxpayers to the potential loss of hundreds of billions of dollars.[1]

  In response to these events, regulators took several steps to require that a key subsector of MMFs—institutional prime funds—report accurate information to their investors about the current market value of their holdings. In a technical sense, this is a requirement that funds report a so-called "floating Net Asset Value" (NAV) which represents the true market value of their holdings, rather than a fixed NAV which gives the impression that each share in a money market fund is worth one dollar. This reform became effective October, 2016.[2] This regulatory change enhances financial stability by helping to ensure that fund investors are prepared for fluctuations in the value of their funds and are less likely to engage in a disorderly exit from the sector when prices start to shift. It also makes clear that shares in MMFs are market investments that carry risk. The floating NAV is designed to lessen the impression that shares in MMFs are similar to insured bank deposits, thus lessening the perception that they are implicitly backed by the government.

  H.R. 2319 would reverse the regulatory response to the crisis by once again permitting institutional prime funds to report an inaccurate fixed value for their holdings, thus encouraging investors to view these instruments as the equivalent of bank deposits—which they are not. Funds affected by this regulatory change are funds invested in by large institutional investors, not retail investors, and only "prime" funds that hold securities not guaranteed by the Federal government are affected.

  H.R. 2319 purports to address any increased threat of a taxpayer bailout by prohibiting any Federal government bailout of MMFs. However, the definition exempts a "facility with

[1] McNamara, Christian, "Temporary Guarantee Program for Money Market Funds," Yale Program on Financial Stability Intervention Case Study, January 13, 2016. Available at: https://ssrn.com/abstract=2723529 or http://bit.ly/2D9lupZ.

[2] "Money Market Fund Reform; Amendments to Form PF," Investment Company Act Release No. 31166, July 23, 2014.

broad-based eligibility established in unusual or exigent circumstances" from the definition of "covered Federal assistance." This language would exempt Federal government assistance provided under Section 13(3) of the Federal Reserve Act from any prohibition on bailouts under this bill—leaving the door wide open to future Federal Reserve assistance to MMFs. Congress should not reverse important regulatory changes made in response to the government bailout of MMFs during the crisis, and should maintain the requirement to report more accurate fund valuations to investors. In recent testimony to the Committee (October 4, 2017), SEC chair Jay Clayton expressed his view that any such change would be premature at best.[3]

- S. 2126, the "Fostering Innovation Act of 2017"
  Related House bill: H.R. 1645

  Previous AFR Statement: H.R. 1645 would double the time for which certain new public companies are exempt from key financial reporting controls, most notably attestation by an auditor that their earnings and accounting are accurate. It grants this exemption to a class of companies, newly public companies with low revenue growth, which have a particular strong incentive to manipulate their financial statements and deceive investors. This bill would both harm investors and undermine the integrity of capital markets.

[3] See Testimony by Jay Clayton on Hearing entitled "Examining the SEC's Agenda, Operations, and Budget," House Committee on Financial Services, October 4, 2017. Available at: http://bit.ly/2fP4POK.

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DJIA 24360.18 0.77% ▲ Nasdaq 7577.00 0.99% ▲ U.S. 10 Yr -2/32 Yield 2.841% ▼ Crude Oil 73.29 -1.15% ▼ Euro 1.1688 0.27% ▲

THE WALL STREET JOURNAL.

https://www.wsj.com/articles/ipo-market-posts-blistering-first-half-1530523801

MARKETS

IPO Market Posts Blistering First Half

U.S., global IPO fundraising is on pace for one of the best years on record

BJ's Wholesale Club Holdings Inc. is one of the companies that has recently raised money through an initial public offering. PHOTO: SCOTT MCINTYRE/BLOOMBERG NEWS

By Maureen Farrell
Updated July 2, 2018 8:26 p.m. ET

An IPO market that was left for dead just two years ago has come roaring back in 2018, with companies raising public capital at a pace rarely seen in the past two decades.

So far this year, 120 companies have used initial public offerings to raise $35.2 billion on U.S. exchanges. That is the highest volume since 2014 and the fourth-busiest year-to-date on record, according to Dealogic, whose data go back to 1995.

Bankers say no single catalyst is pushing companies to tap the public markets for capital. Instead, the surge has been caused by a convergence of favorable business conditions, strong stock markets and investors' hunger for high-growth companies.

Those factors have led to offerings by an array of firms varied by size, industry and age—ranging from the web-storage and collaboration company Dropbox Inc. DBX -2.22% ▼ to home-alarm company ADT Inc. ADT -0.99% ▼ to big-box retailer BJ's Wholesale Club Holdings Inc.

The total amount raised doesn't count one of the largest and most high-profile companies to go public in the U.S. this year. Swedish music-sharing company Spotify Technology SA went public without raising any money through a so-called direct listing.

IPO issuance began to pick up pace last year after a moribund 2016. Helping along this year's rush: Companies are no longer worried they may have to go public at valuations below those they had achieved in the private markets, as a disconnect has largely been erased between public and private-market valuations.

Bankers and lawyers expect the rapid IPO pace to continue for the rest of the year.

"Our global IPO pipeline is stronger now than it's been since the financial crisis," said Evan Damast, global head of equity and fixed income syndicate at Morgan Stanley .

Companies that have gone public in the U.S. this year are trading, on average, 22% above their IPO price, and technology companies have done particularly well, up 53% above their IPO price, according to Dealogic data through Thursday's close of trading. Meanwhile, the S&P 500 rose less than 2% for the year and the tech-heavy Nasdaq Composite climbed 8.7%, during the same period.

"This year we're finding the investor demand for technology IPOs is literally the highest we've ever seen both in terms of the quantity and quality of interest," said Madhu Namburi, JPMorgan Chase & Co.'s head of technology investment banking.

Not that this has dented private-market activity. Many companies continue to raise vast sums there. That companies are tapping both private and public markets defies expectations that companies would largely turn to IPOs once private funding tightened. Activity so far this year has made it clear both markets can thrive in tandem, at least for now.

"Private markets primarily facilitate companies to raise capital. A public IPO is a landmark event for a company that goes far beyond just raising capital," said Mr. Namburi. Employees of public companies, he said, have a clear sense of the wealth they've earned, and public companies have a currency to use for acquisitions and for future capital-raising.

The largest private companies, including Airbnb Inc., Uber Technologies Inc. and WeWork Cos., which have raised vast amounts of private capital, are expected to hold off on going public until at least 2019, according to people familiar with the companies' plans.

Another closely watched IPO candidate, ride-hailing firm Lyft Inc., recently raised $600 million from mutual fund and hedge-fund investors including Fidelity Investments.

And SoftBank Group Corp. continues to pour money into private companies through its $92 billion tech-focused Vision Fund, extending the IPO timelines of its portfolio companies—and pushing up their private valuations.

Bankers expect to see a steady pace of multibillion-dollar technology companies going public in the U.S. the rest of this year. Among them: Sonos Inc.; Upwork; SurveyMonkey; and Eventbrite Inc.

Tech IPOs, mostly software companies, have been going strong, raising $12.2 billion in 28 deals in the first half of 2018, nearly double the volume from the same period in 2017 and a more-than-tenfold increase from 2016's volume, according to Dealogic.

The largest IPOs in the second half of 2018 are expected to come out of China. Many of the largest Chinese companies planning to debut in 2018, including Meituan Dianping and Xiaomi Corp., will do so in Hong Kong as its stock exchange changed its listing rules this year to allow companies with dual-class shares to list there.

An exception is Tencent Music Entertainment Group, China's largest music-streaming company, which is expected to go public in the U.S. and is expected to be one of the largest IPOs of the year, according to people familiar with the deal.

While 2018 could be a near-record year, bankers and lawyers are betting activity could continue to accelerate from there. "There's a real chance that 2019 could be even stronger than 2018," said JPMorgan Chase's Mr. Namburi.

Write to Maureen Farrell at maureen.farrell@wsj.com

Corrections & Amplifications
So far this year, 120 companies have used initial public offerings to raise $35.2 billion on U.S. exchanges. That is the highest volume since 2014. An earlier version of this article incorrectly said it was the highest volume since 2012.

Appeared in the July 3, 2018, print edition as 'IPO Market Runs at Fastest Clip Since 2014.'

United States Government Accountability Office

Report to Congressional Committees

July 2013

INTERNAL CONTROLS

SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation

GAO-13-582

July 2013

GAO Highlights

Highlights of GAO-13-582, a report to congressional committees

INTERNAL CONTROLS

SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation

Why GAO Did This Study

Section 404(b) of the Sarbanes-Oxley Act requires a public company to have its independent auditor attest to and report on management's internal control over financial reporting; this is known as the auditor attestation requirement. In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act exempted companies with less than $75 million in public float from the auditor attestation requirement. The act mandated that GAO examine the impact of the permanent exemption on the quality of financial reporting by small public companies and on investors. This report discusses (1) how the number of financial statement restatements compares between exempt and nonexempt companies (i.e., those with $75 million or more in public float), (2) the costs and benefits of complying with the attestation requirement, and (3) what is known about the extent to which investor confidence is affected by compliance with the auditor attestation requirement. GAO analyzed financial restatements and audit fees data; surveyed 746 public companies with a response rate of 25 percent; interviewed regulatory officials and others; and reviewed laws, surveys, and studies.

What GAO Recommends

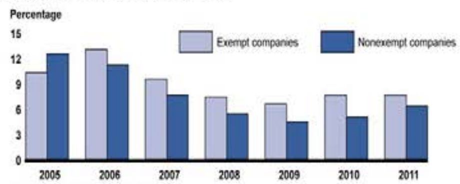
GAO recommends that SEC consider requiring public companies, where applicable, to explicitly disclose whether they obtained an auditor attestation of their internal controls. SEC responded that investors could determine attestation status from available information. But without clear disclosure, investors may misinterpret a company's status; therefore, this warrants SEC's further consideration.

View GAO-13-582. For more information, contact A. Nicole Clowers at (202) 512-8678 or clowersa@gao.gov.

What GAO Found

Since the implementation of the auditor attestation requirement of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), companies exempt from the requirement have had more financial restatements (a company's revision of publicly reported financial information) than nonexempt companies, and the percentage of exempt companies restating generally has exceeded that of nonexempt companies. Exempt and nonexempt companies restated their financial statements for similar reasons (e.g., revenue recognition and expenses), and the majority of these restatements produced a negative effect on the companies' financial statements.

Percentage of Exempt and Nonexempt Companies That Restated Their Financial Statements, 2005 to 2011



Source: GAO analysis of Audit Analytics data.

Note: Nonexempt companies first complied with the Section 404(b) requirement for their first fiscal year ending on or after November 15, 2004. Exempt companies never had to comply with the requirement.

Views on the costs and benefits of auditor attestation vary among companies and others. Although companies and others reported that the costs associated with compliance can be significant, especially for smaller companies, GAO's and others' analyses show that these costs have declined for companies of all sizes since 2004. Companies and others reported benefits of compliance, such as improved internal controls and reliability of financial reports. However, measuring whether auditor attestation compliance costs outweigh the benefits is difficult and views among companies and others were mixed as to whether the costs exceeded the benefits of compliance.

A majority of empirical studies GAO reviewed suggest that compliance with the auditor attestation requirement has a positive impact on investor confidence in the quality of financial reports. Some interviewees said the independent scrutiny of a company's internal controls is an important investor protection safeguard. The Securities and Exchange Commission (SEC) does not require exempt companies to disclose in their annual report whether they voluntarily obtained an auditor attestation. SEC officials said it is not common for SEC to require a company to disclose voluntary compliance with requirements from which it is exempt. However, federal securities laws require companies to disclose relevant information to investors to aid in their investment decisions. Although information on auditor attestation status is available to investors, requiring a company to explicitly state whether it has obtained an auditor attestation on internal controls could increase transparency and investor protection.

Contents

Figures

GAO U.S. GOVERNMENT ACCOUNTABILITY OFFICE

441 G St. N.W.
Washington, DC 20548

July 3, 2013

The Honorable Tim Johnson
Chairman
The Honorable Mike Crapo
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Jeb Hensarling
Chairman
The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
House of Representatives

Public and investor confidence in the accuracy, reliability, and transparency of companies' financial reporting is critical to the effective functioning of U.S. capital markets. In response to a series of high-profile corporate accounting scandals that resulted in substantial losses to investors at the start of the last decade, Congress passed the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act).[1] The act introduced major reforms to public company financial reporting and auditing that were intended to, among other things, improve the reliability of financial reporting and enhance audit quality. Effective internal controls are a key focus of these reforms. In particular, Section 404(b) of the act—the auditor attestation requirement—requires that each public company's independent auditor annually attest to and report on management's assessment of the effectiveness of the company's internal control over financial reporting.[2] The auditor determines whether any material weaknesses exist as of year-end.

[1]Pub. L. No. 107-204, 116 Stat. 745 (2002).

[2]Section 404(b) applies to companies required to file reports with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934. *Id* at § 404(a). Registered investment companies and asset-backed issuers generally are exempt from Section 404(b). *See* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports, 68 Fed. Reg. 36,636 (June 18, 2003).

The auditor attestation requirement has been subject to much debate since its inception. Congress, business groups, regulators, consumer, investor and auditing groups, and academics have debated the need for small public companies (generally considered to be public companies with a publicly available stock value of less than $75 million) to comply with the auditor attestation requirement. Opponents of the requirement argue that compliance is too costly, especially for small public companies. In contrast, proponents of the requirement argue that, generally, small public companies lack adequate internal controls and restate their financial statements—that is, revise their financial statements to correct accounting errors—more often than large companies. Therefore, they argue, the requirement provides an important investor protection safeguard by ensuring independent scrutiny of a company's financial reporting process.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) Section 989G, amended the Sarbanes-Oxley Act so that Section 404(b) does not apply with respect to "any audit report prepared for an issuer that is neither a 'large accelerated filer' nor an 'accelerated filer' as those terms are defined" by the Securities and Exchange Commission (SEC).[3] By adding Section 404(c) to the Sarbanes-Oxley Act, Section 989G permanently exempted smaller issuers from the requirement to obtain an auditor's attestation on management's assessment of the company's effectiveness of internal control over financial reporting.[4] At the time of enactment in 2010, Section 989G affected about 5,500 small public companies, representing about 61

[3]Pub. L. No. 111-203, § 989G(a), 124 Stat. 1376, 1948 (2010). SEC refers to small public companies and large public companies as nonaccelerated filers and accelerated filers, respectively, and uses a public float measurement to determine the category of filer. Although the term "nonaccelerated filer" is not defined in SEC rules, it refers to a reporting company that does not meet the definition of either an "accelerated filer" or a "large accelerated filer" under the Securities Exchange Act of 1934 Rule 12b-2. 17 C.F.R. § 240.12b-2. An accelerated filer generally is a company that has been public for at least 12 months and, among other things, had at least $75 million but less than $700 million in public float as of the last business day of its most recently completed second fiscal quarter and filed at least one annual report with SEC. A large accelerated filer generally is a company that has been public for at least 12 months and, among other things, had a public float of $700 million or more as of the last business day of its most recently completed second fiscal quarter and filed at least one annual report with SEC. SEC defines public float as the worldwide aggregate market value of voting and nonvoting common equity held by nonaffiliates of the filer.

[4]§ 989G(a).

percent of all public companies, by exempting them from the requirement.[5]

Section 989I of the Dodd-Frank Act mandated us to study and report on the impact of the permanent exemption on the quality of financial reporting by smaller public companies and on investors.[6] This report discusses: (1) how the number of financial statement restatements compares between exempt and nonexempt companies; (2) the costs and benefits for nonexempt companies and exempt companies that voluntarily comply with the auditor attestation requirement; and (3) what is known about the extent to which investor confidence in the integrity of financial statements is affected by whether or not companies comply with the auditor attestation requirement. For the purposes of this report, we define exempt companies as those with less than $75 million in public float (nonaccelerated filers) and nonexempt companies as those with $75 million or more in public float (accelerated filers).

To identify the number of financial statement restatements (referred to as financial restatements) and trends, we analyzed data from Audit Analytics' Restatement database, which contains company information (such as assets, revenues, restatements, market capitalization, location, and industry classification code) for 2005 through 2011.[7] We identified 6,436 financial restatements by 4,536 public companies, 2,834 of which were exempt companies.[8] We used Audit Analytics' 69 classifications to classify the type of financial restatements into six categories: core expenses (i.e., ongoing operating expenses), noncore expenses (i.e., nonoperating or nonrecurring expenses), revenue recognition, reclassifications and disclosures, underlying events (i.e., accounting for mergers or acquisitions), and other (e.g., restatements related to

[5]See Securities and Exchange Commission, *Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers with Public Float Between $75 and $250 Million* (Washington, D.C.: April 2011).

[6]§ 989I(a)-(b).

[7]Audit Analytics is an online market intelligence service that provides information on SEC registrants. Audit Analytics maintains a proprietary database containing information from the filings public companies submit to SEC, such as audit fees, audit opinions, and financial restatements.

[8]The number of financial restatements exceeds the number of public companies issuing financial restatements because some of these companies restated their financial statements more than once.

pensions and any other issues identified in the restatement).[9] To identify audit costs of compliance, we analyzed data from Audit Analytics' Auditor Opinion database, which contains auditors' report information, including audit fees, nonaudit fees, auditor name, audit opinions, revenues, and company size, for 2005 through 2011. Our analyses of audit costs do not include 2012 data because some of the data for small companies were incomplete as we concluded our analysis. According to Audit Analytics, the incomplete data was often due to the fact that the small companies had not yet filed the relevant information with SEC. In addition, although 2012 restatement data are available, we were unable to conduct some of our analyses of restatements for 2012 because of incomplete 2012 small-company data in the Auditor Opinion database. We tested samples of the Audit Analytics database information and found it to be reliable for our purposes.

To obtain information on large and small public companies' experiences with the costs and benefits of complying with the auditor attestation requirement and the extent to which investor confidence in the integrity of financial statements is affected by companies' compliance with the requirement (referred to as auditor attestation status), we identified a population of 4,053 companies that fit within the scope of our review. To define the population, we obtained a list of all publicly traded companies for calendar years 2004 through 2011 from Audit Analytics. We stratified the population into three strata by first identifying the nonaccelerated filers that voluntarily complied with the integrated audit requirement in any year from 2004 through 2011. We excluded from our population any exempt company that did not obtain an auditor attestation of its internal controls and then stratified the remaining companies into accelerated filers and large accelerated filers.[10] We surveyed all nonaccelerated filers that

[9] Susan Scholz, *The Changing Nature and Consequences of Public Company Financial Restatements: 1997-2006*, a special report prepared at the request of the Department of the Treasury, April 2008. Five of the six categories are based on the classification scheme developed by academics Zoe-Vonna Palmrose and Susan Scholz. The remaining category ("other") was developed by GAO and comprises financial restatements that were not included in one of the other categories.

[10] To identify accelerated filers and large accelerated filers, we relied upon the companies' SEC filing status, which is based on public float. In instances in which companies did not disclose their filing status, we relied upon the companies' market capitalization, as reported in the Audit Analytics database, to make an independent determination of likely filing status. Market capitalization is defined as the total dollar market value of all of a firm's outstanding shares and is calculated by multiplying a firm's outstanding shares by the current market price of one share.

voluntarily complied as well as a random sample of both strata of accelerated filers for a total survey population of 746 companies. We received valid responses from 195 companies. The weighted response rate for this survey, which accounts for the differential sampling fractions within each strata, was 25 percent. All percentage estimates presented in this report have a margin of error of plus or minus 15 percentage points or fewer, and all estimates of averages have a relative margin of error of plus or minus 20 percent or less, unless otherwise noted.

For all three objectives, we interviewed representatives of small public companies, regulatory bodies (SEC and Public Company Accounting Oversight Board (PCAOB)), trade associations (representing individual and institutional investors, accounting firms, financial analysts and investment professionals, and financial executives), industry experts, a large pension fund, a credit rating agency, and academics knowledgeable about accounting issues. We also reviewed relevant academic, industry, and SEC research studies and surveys.[11] Appendix I contains a more detailed description of our scope and methodology.

We conducted this performance audit from May 2012 to July 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Internal control generally serves as a first line of defense for public companies in safeguarding assets and preventing and detecting errors and fraud. Internal control is defined as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of the following objectives: (1) effectiveness and efficiency of operations; (2) reliability of financial reporting; and (3) compliance with laws and regulations.[12]

[11]See the bibliography for a detailed list of sources reviewed.

[12]COSO, Internal Control – Integrated Framework, 1992, 1994, and 2013. The "reliability of financial reporting" objective is the objective that is relevant for purposes of Section 404 and the SEC's implementing rules.

Internal control over financial reporting is further defined in the SEC regulations implementing Section 404 of the Sarbanes-Oxley Act.[13] These regulations define internal control over financial reporting as a means of providing reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements, including those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.[14]

Regulators regard an effective internal control system as a foundation for high-quality financial reporting by companies. Title IV, Section 404 of the Sarbanes-Oxley Act, aims to help protect investors by, among other things, improving the accuracy, reliability, and transparency of corporate financial reporting and disclosures. Section 404 has the following two key sections:

- Section 404(a) requires company management to state its responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting and assess the effectiveness of its internal control over financial reporting in each annual report filed with SEC.[15] In 2007, SEC issued guidance for

[13] Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports, 68 Fed. Reg. 36636 (June 18, 2003) (amending 17 C.F.R. §§ 210, 228, 229, 240, 249, 270, and 274).

[14] *Id.*

[15] Pub. L. No. 107-204, § 404(a), 116 Stat. 745, 789 (2010) (codified as amended at 15 U.S.C. § 7262).

management regarding its report on internal control over financial reporting.[16]

- Section 404(b) requires the firms that serve as external auditors for public companies to provide an opinion on the internal control assessment made by the companies' management regarding the effectiveness of the company's internal control over financial reporting as of year-end.[17] In 2007, PCAOB issued Auditing Standard No. 5, which contains the requirements that apply when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting.[18]

While management is responsible for the implementation of an effective internal control process, the external auditor obtains reasonable assurance to provide an opinion on the effectiveness of a company's internal control over financial reporting through an independent audit. Investors need to know that the financial statements on which they make investment decisions are reliable. The auditor attestation process involves the external auditor's testing and evaluation of the company's internal control over financial reporting and relevant documentation in order to provide an opinion on the effectiveness of the company's internal control over financial reporting as of year-end; a company's internal control over financial reporting cannot be considered effective if one or more material weaknesses exist.[19]

Auditor attestation of the effectiveness of internal control over financial reporting has been required for public companies with a public float of

[16] *Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*, Interpretation, SEC Release No. 33-8810 (June 20, 2007).

[17] § 404(b).

[18] Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements* (PCAOB 2007).

[19] SEC and PCAOB define a material weakness as a deficiency, or combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the firm's annual or interim financial statements will not be prevented or detected on a timely basis. *See* SEC Regulation S-X, 17 C.F.R. § 210.1-02(a)(4); Auditing Standard No. 5.

$75 million or more (accelerated filers) since 2004.[20] However, SEC delayed implementing the auditor attestation for public companies with less than $75 million in public float (nonaccelerated filers) several times from the original compliance date of April 15, 2005, to June 15, 2010, in response to concerns about compliance costs and management and auditor preparedness.[21] On July 21, 2010, the Dodd-Frank Act permanently exempted nonaccelerated filers from the auditor attestation requirement.[22] The Dodd-Frank Act did not exempt nonaccelerated filers from Section 404(a) of the Sarbanes-Oxley Act (management's assessment of internal controls). See table 1 for final compliance dates for internal control over financial reporting by issuer filer status.

[20]Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports, 68 Fed. Reg. at 36,647.

[21]GAO, *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings*, GAO-12-881 (Washington, D.C.: Sep. 13, 2012).

[22]Pub. L. No. 111-203, § 989G(a), 124 Stat. 1376, 1948 (2010) (codified at 15 U.S.C.§7262) (amending Sarbanes-Oxley Act). SEC amended its rules and forms to conform to Section 404(c) of the Sarbanes-Oxley Act, as added by Section 989G of the Dodd-Frank Act. *See* Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, 75 Fed. Reg. 57,385 (Sept. 21, 2010). Section 404(c) provides that Section 404(b) of the Sarbanes-Oxley Act shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b–2 under the Securities Exchange Act of 1934. Pub. L. No. 107-204, § 404(c), 116 Stat. 745, 789 (2010) (codified as amended at 15 U.S.C. § 7262). Additionally, the Jumpstart Our Business Startups Act ("JOBS Act") also exempted emerging growth companies, defined generally as issuers with less than $1 billion in annual gross revenue, from the auditor attestation requirement of Section 404(b) as long as the issuer retains emerging growth company status, which is subject to four conditions. Among other conditions, an issuer will ordinarily no longer retain emerging growth company status at the end of the fiscal year in which the fifth anniversary of its initial public offering of common equity securities occurs. Pub. L. No. 112-106, § 103, 126 Stat. 306, 310 (2012). In addition, our study did not specifically address the impact of this JOBS Act exemption on the number of exempt companies, the number of restatements by exempt companies, the auditor attestation practices of newly public companies or investor perception of the reliability of financial statements of emerging growth companies.

Table 1: Sarbanes-Oxley Act Section 404 Requirements Compliance Dates by Filer Status Set by SEC

	Issuer filer status	Compliance dates for internal control over financial reporting requirements: Management's report on internal controls and effectiveness	Compliance dates for internal control over financial reporting requirements: External auditor's attestation report on internal controls and effectiveness
U.S. issuer	Large accelerated filer or accelerated filer ($75 million or more in public float)	Annual reports filed with SEC for fiscal years ending on or after November 15, 2004	Annual reports filed with SEC for fiscal years ending on or after November 15, 2004
	Nonaccelerated filer (less than $75 million in public float)	Annual reports filed with SEC for fiscal years ending on or after December 15, 2007	Permanently exempted by Dodd-Frank Act on July 21, 2010
Foreign private issuer	Large accelerated filer ($700 million or more in public float)	Annual reports filed with SEC for fiscal years ending on or after July 15, 2006	Annual reports filed with SEC for fiscal years ending on or after July 15, 2006
	Accelerated filer ($75 million or more and less than $700 million in public float)	Annual reports filed with SEC for fiscal years ending on or after July 15, 2006	Annual reports filed with SEC for fiscal years ending on or after July 15, 2007
	Nonaccelerated filer (less than $75 million in public float)	Annual reports filed with SEC for fiscal years ending on or after December 15, 2007	Permanently exempted by Dodd-Frank Act on July 21, 2010
Newly public company (U.S. or foreign private issuer)	Large accelerated filer or accelerated filer ($75 million or more in public float)	Second annual report filed with SEC following company's initial public offering	Second annual report filed with SEC following company's initial public offering
	Nonaccelerated filer (less than $75 million in public float)	Second annual report filed with SEC following company's initial public offering	Permanently exempted by Dodd-Frank Act on July 21, 2010

Sources: GAO and SEC.

Note: Foreign private issuers are generally foreign companies that have a relatively lesser degree of U.S. share ownership or U.S. business contacts. SEC has adopted special rules applicable to foreign private issuers that are designed to recognize international and home jurisdiction. 17 C.F.R. § 240.3b-4; 17 C.F.R. § 230.405.

The number of exempt companies exceeded the number of nonexempt companies in each year from 2005 through 2011 (see table 2). According to our analysis of Audit Analytics data, the number of exempt companies fluctuated and ultimately declined from 6,333 in 2005 to 5,459 in 2011 (13.8 percent during that period). The number of nonexempt companies also fluctuated and ultimately declined from 4,256 in 2005 to 3,671 in 2011(13.7 percent).

Table 2: Number of Exempt and Nonexempt Companies, 2005-2011

Year	Number of exempt companies	Number of nonexempt companies
2005	6,333	4,256
2006	5,858	4,455
2007	5,530	4,437
2008	5,915	4,166
2009	6,285	3,697
2010	6,166	3,586
2011	5,459	3,671

Source: GAO analysis of Audit Analytics data.

Note: The number of exempt companies includes companies that voluntarily complied with the auditor attestation requirement. Company estimates in the table do not include subsidiaries of a public company, registered investment companies, or asset-backed securities issuers. Exempt companies are nonaccelerated filers, including smaller reporting companies. For our purposes, we grouped companies that did not disclose their filing status but whose market capitalization was less than $75 million with exempt companies. For example, companies that did not disclose their filing status include Canadian Form 40-F filers. We used market capitalization as a proxy for public float in these instances because the Audit Analytics database did not contain information on companies' public float. Nonexempt companies are accelerated filers and large accelerated filers. For our purposes, we grouped companies that did not disclose their filing status but whose market capitalization was equal to or greater than $75 million with nonexempt companies. We excluded companies that did not disclose their filing status and that did not have a reported market capitalization.

SEC and PCAOB have issued regulations, standards, and guidance to implement the Sarbanes-Oxley Act. In 2007, in response to companies' concerns about implementation costs, SEC provided implementation guidance to company management, and PCAOB issued a new auditing standard to external auditors to make the internal controls audit process more efficient and more cost-effective.[23] SEC's guidance for management in implementing Section 404(a) of Sarbanes-Oxley Act and PCAOB's Auditing Standard No. 5 for external auditors in implementing Section 404(b) of Sarbanes-Oxley Act endorsed a "top-down, risk-based approach" that emphasizes preventing or detecting material misstatements in financial statements by focusing on those risks that are more likely to contribute to such misstatements. These changes were provided to create a more flexible environment where company management and external auditors can scale their internal controls

[23] *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*, Interpretation, 72 Fed. Reg. 35,324 (June 27, 2007); and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements* (PCAOB 2007).

evaluation based on the particular characteristics of a company to reduce costs and to align SEC and PCAOB requirements for evaluating the effectiveness of internal controls.

Both SEC regulations and PCAOB Auditing Standard No. 5 state that management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due process procedures. Both the SEC guidance and PCAOB's auditing standard cite the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework as an example of a suitable framework for purposes of Section 404 compliance.[24] In 1992, COSO issued its "Internal Control—Integrated Framework" (the COSO framework) to help businesses and other entities assess and enhance their internal controls. Since that time, the COSO framework has been recognized by regulatory standard setters and others as a comprehensive framework for evaluating internal control, including internal control over financial reporting.[25] The framework consists of five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring.[26] However, SEC and PCAOB do not mandate the use of any particular framework.

[24]COSO was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private-sector initiative that studied the causal factors that can lead to fraudulent financial reporting and developed recommendations for public companies and their independent auditors, SEC and other regulators, and educational institutions.

[25]COSO, *Internal Control – Integrated Framework*, 1992, 1994, and 2013.

[26]On May 14, 2013, COSO issued an update to its 1992 Internal Control-Integrated Framework to: (1) reflect a business environment that is more complex than it was when the original framework was developed; (2) broaden the application of internal control in addressing operations and reporting objectives; and (3) clarify what constitutes effective internal control.

The Percentage of Exempt Companies with Financial Restatements Was Generally Greater Than the Percentage of Nonexempt Companies from 2005 through 2011

Since the implementation of the Sarbanes-Oxley Act, the number and percentage of exempt companies restating their financial statements has generally exceeded the number and percentage of nonexempt companies restating. However, from 2005 through 2011, restatements by exempt companies were generally proportionate to their percentage of our total population. Specifically, on average, almost 64 percent of companies restating were exempt companies and exempt companies made up, on average, 60 percent of our total population. Exempt and nonexempt companies restated their financial statements for similar reasons, and the majority of these restatements produced a negative effect on the companies' financial statements.

Exempt Companies Generally Have Had More Financial Restatements Than Nonexempt Companies

The number of financial statement restatements by exempt and nonexempt companies has generally declined since 2005. As illustrated in figure 1, the number of financial restatements peaked in 2006 for exempt companies and declined gradually until 2011, despite a slight uptick in 2010. The number of restatements peaked in 2005 for nonexempt companies, declined gradually until 2009, and then trended upward for the remaining 2 years of the review period. As we have previously reported, some industry observers noted the financial reporting requirements of the Sarbanes-Oxley Act and PCAOB inspections may have led to a higher than average number of restatements in 2005 and 2006.[27] A 2010 Audit Analytics report noted that some observers attributed the subsequent decline in restatements to a belief that SEC relaxed standards in 2008 relating to materiality of errors and the need to file restatements.[28] The number of financial restatements by exempt companies exceeded the number of financial restatements by nonexempt companies each year from 2005 through 2011. However, although the overall number of financial restatements from 2009 through 2011 remained lower than the prior period, the number of financial restatements by nonexempt companies increased about 23 percent from

[27]GAO, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities*, GAO-06-678 (Washington, D.C.: Mar. 5, 2007).

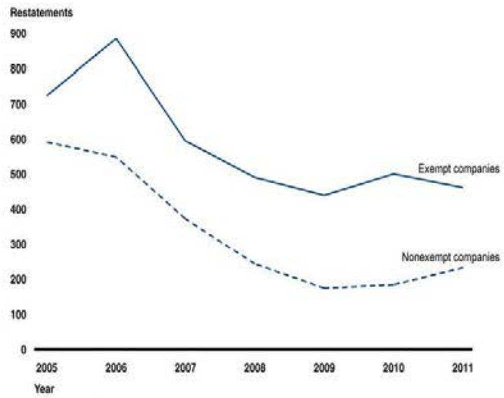
[28]Audit Analytics, *2009 Financial Restatements: A Nine Year Comparison* (Sutton, Mass.: February 2010).

2010 through 2011. The number of financial restatements by exempt companies declined almost 8 percent during the same period.

SEC officials and one market expert with whom we spoke indicated that there is no clear explanation for these restatement trends. They also said that a review of each individual financial restatement would be necessary to determine the reasons for the restatement trends, but they offered a few factors to consider when assessing the trends. In particular, a recent Audit Analytics report found that approximately 57 percent of restatements disclosed in 2011 were defined as revision restatements, the highest level since 2005 (the first full year of the disclosure requirement).[29] According to the report, revision restatements generally do not undermine reliance on past financials and are less disruptive to the market. SEC officials noted that although restatements by nonexempt companies have increased, as illustrated in the Audit Analytics report, they may be less severe as a result of higher numbers of revision restatements, fewer issues per restatement, and a lower cumulative impact on the company's net income. According to our analysis of Audit Analytics data, in 2011, the percentage of restatements that were revision restatements was approximately 62 percent for exempt companies compared to approximately 70 percent for nonexempt companies. SEC officials also suggested that the detection rate of financial restatements could affect restatement trends, especially when looking only at a one or two year period. The officials said that the lag time on detection and the likelihood of detection could be different between exempt and nonexempt companies. Finally, SEC officials said that it is important to consider the nature and severity of restatements.

[29]Audit Analytics, *2011 Financial Restatements: An Eleven Year Comparison* (Sutton, Mass.: April 2012). A revision restatement is defined as a restatement contained in a periodic report without prior disclosure in Form 8-K, Item 4.02. SEC requires public companies to disclose a determination that any previously issued financial statements should no longer be relied upon. Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 69 Fed. Reg. 15,594 (Mar. 25, 2004).This set of disclosure requirements became effective August 23, 2004. *Id.*

Figure 1: Number of Restatements by Exempt Companies and Nonexempt Companies, 2005-2011



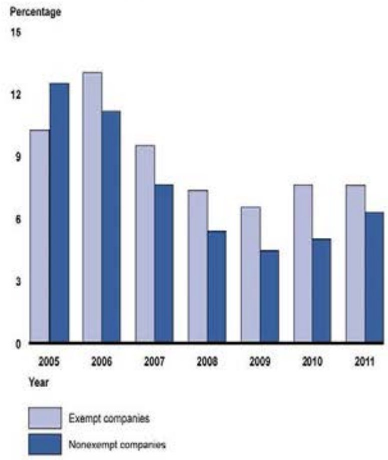
Source: GAO analysis of Audit Analytics data.

Note: The data for this table include the number of restatements disclosed in each calendar year from 2005 through 2011.

Except for 2005, the percentage of exempt companies restating their financial statements exceeded the percentage of nonexempt companies restating. From 2006 through 2009, there was a decline in the percentage of restatements for both exempt companies and nonexempt companies. The percentage of exempt companies restating their financial statements rose in 2010 to 7.6 percent and remained constant in 2011 (see fig. 2).[30] At the same time, starting in 2010, the percentage of nonexempt companies restating has been on the increase. In addition, from 2005 to 2011, on average, almost 64 percent of companies restating were exempt companies, which made up 60 percent of our total population.

[30]The data reflect the unique number of exempt and nonexempt companies restating in each calendar year, independent of the period or periods being restated. The percentage is calculated by dividing the number of unique restating exempt companies in a given year by the total population of unique exempt companies for that year.

Figure 2: Percentage of Exempt and Nonexempt Companies That Restated Their Financial Statements, 2005-2011



Source: GAO analysis of Audit Analytics data.

Note: The data for this table are based on the proportion of the unique number of exempt and nonexempt companies disclosing a restatement each calendar year divided by the respective populations for fiscal years 2005 through 2011.

Our analysis is generally consistent with a number of studies that have found that exempt companies restate their financial statements at a higher rate than nonexempt companies.[31] These studies suggest that having an auditor attest to the effectiveness of a company's internal control over financial reporting generally reduces the likelihood of financial restatements. For example, in 2009, Audit Analytics found that for companies that did not obtain an auditor attestation and stated that

[31] Securities and Exchange Commission, *Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers with Public Float Between \$75 and \$250 Million* (Washington, D.C.: April 2011); Audit Analytics, *Restatements Disclosed by the Two Types of SOX 404 Issuers: (1) Auditor Attestation Filers and (2) Management-Only Report Filers* (Sutton, Mass., November 2009); and A. Nagy, "Section 404 Compliance and Financial Reporting Quality," *Accounting Horizons*, vol. 24, no. 3 (2010).

they had effective internal controls, their financial restatement rate was 46 percent higher than the restatement rate for companies that had obtained an auditor attestation and stated that they had effective internal controls.[32]

Exempt Companies That Voluntarily Complied with Auditor Attestation Issued Fewer Restatements Than Exempt Companies That Did Not

Exempt companies that voluntarily complied with the auditor attestation requirement constitute a small percentage of exempt companies (see table 3). Prior to the passage of the Dodd-Frank Act in July 2010, the number of exempt companies voluntarily complying with the auditor attestation requirement grew 70 percent from 2008 through 2009. Although SEC deferred the requirement for nonaccelerated filers to comply until June 15, 2010, some exempt companies likely voluntarily complied in anticipation of SEC's implementation of the requirement.[33] Nonetheless, in 2009 during the peak compliance period for exempt companies that voluntarily complied, 6.9 percent (435) of a total population of 6,285 exempt companies voluntarily complied with the auditor attestation requirement. According to one academic study, exempt companies that voluntarily comply with the auditor's attestation requirement are more likely than companies that do not comply to have evidence of the superior quality of their internal control over financial reporting and fewer restatements, among other factors.[34]

[32]Audit Analytics, *Restatements Disclosed by the Two Types of SOX 404 Issuers: (1) Auditor Attestation Filers and (2) Management-Only Report Filers* (Sutton, Mass., November 2009). Audit Analytics uses SEC data for its analysis, and SEC and PCAOB define internal control over financial reporting as effective if a material weakness does not exist. *See* SEC Regulation S-K, 17 C.F.R § 229.308(a)(3); Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that Is Integrated with an Audit of Financial Statements (PCAOB 2007).

[33]Prior to issuing several temporary exemptions from the auditor attestation requirement, SEC issued guidance stating that nonaccelerated (exempt) companies were not required to obtain an auditor's report on internal control over financial reporting until the company filed an annual report for its fiscal year ending on or after April 15, 2005. See Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports, 68 Fed. Reg. at 36,651.

[34]See K. Brown, P. Pacharn, J. Li, E. Mohammad, F. A. Elayan, and F. Chu, "The Valuation Effect and Motivations of Voluntary Compliance with Auditor's Attestation Under Sarbanes-Oxley Act Section 404 (B)," Working paper, (Jan. 15, 2012).

Table 3: Number of Exempt Companies That Did and Did Not Voluntarily Comply with the Auditor Attestation Requirement and the Percentage of Companies That Filed Restatements, 2005-2011

	Exempt companies that did not voluntarily comply			Exempt companies that voluntarily complied			Total exempt companies		
Year	Total number	Total number restating	Percent restating	Total number	Total number restating	Percent restating	Total number	Total number restating	Percent restating
2005	6,253	643	10.28%	80	7	8.75%	6,333	650	10.26%
2006	5,755	750	13.03	103	12	11.65	5,858	762	13.01
2007	5,370	513	9.55	160	12	7.50	5,530	525	9.49
2008	5,659	418	7.39	256	17	6.64	5,915	435	7.35
2009	5,850	387	6.62	435	24	5.52	6,285	411	6.54
2010	5,816	453	7.79	350	16	4.57	6,166	469	7.61
2011	5,160	392	7.60	299	23	7.69	5,459	415	7.60

Source: GAO analysis of Audit Analytics data.

As table 3 also shows, the percentage of financial restatements by exempt companies that voluntarily complied with the requirement is generally lower than that of exempt companies that did not voluntarily comply. From 2005 through 2011, on average, 7.5 percent of exempt companies that voluntarily complied restated their financial statements compared to 8.9 percent of restating exempt companies that did not voluntarily comply.

Reasons for Financial Restatement and Industry Trends Are Generally Consistent for Both Exempt and Nonexempt Companies

From 2005 through 2011, based on our analysis of Audit Analytics data, the majority of exempt and nonexempt companies that restated their financial statements did so as the result of an accounting rule misapplication.[35] That is, a company revised previously issued public financial information that contained an accounting inaccuracy. To analyze the reasons for financial restatements, we used Audit Analytics' 69 classifications to classify the type of financial restatements into six categories (see table 4): revenue recognition, core expenses, noncore

[35]An "accounting rule misapplication" refers to the misapplication of Generally Accepted Accounting Principles.

expenses, reclassifications and disclosures, underlying events, and other.[36]

Table 4: Financial Restatement Category Descriptions

Category	Description
Revenue recognition	Restatements due to improper revenue accounting. This category includes restatements originating from a failure to properly interpret sales contracts for hidden rebate, return, barter, or resale clauses. They may also relate to the treatment of sales returns, credits, and other allowances.
Core expenses	Restatements of companies' ongoing operating expenses. This category includes cost of sales, compensation expenses, lease and depreciation costs, selling, general and administrative expenses, and research and development costs.
Noncore expenses	Restatements that affect net income but do not arise from ongoing operating expenses. This category includes accounting for interest, taxes, and derivatives. It also includes misstatements arising from accounting for nonrecurring events.
Reclassifications and disclosures	Restatements due to improperly classified financial statement items (e.g., current liabilities classified as long-term debt on the balance sheet, or cash flows from operating activities classified as cash flows from financing activities on the statement of cash flows). This category includes restatements that generally revise footnote information.
Underlying events	Restatements due to improper accounting for acquisitions or mergers and issues from problems with foreign affiliates and their related accounting or financial reporting.
Other	Any restatement not covered by the listed categories. This category includes restatements related to pensions and any other issues identified in the restatement

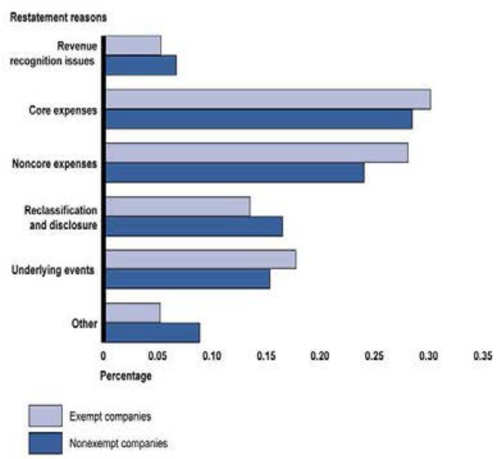
Sources: Zoe-Vonna Palmrose and Susan Scholz and GAO.

Based on our classification, core expenses (i.e., ongoing operating expenses) were the most frequently identified category of restatement for both exempt and nonexempt companies. Specifically, core expenses accounted for 30.2 percent of disclosures by exempt companies and 28.5

[36]Five of the six categories are based on the classification scheme developed by academics Zoe-Vonna Palmrose and Susan Scholz. The sixth category ("other") was developed by GAO and comprises financial restatements that were not included in one of the other categories.

percent of disclosures by nonexempt companies from 2005 through 2011 (see fig. 3). Core expenses include cost of sales, compensation expenses, lease and depreciation costs, selling, general and administrative expenses, and research and development costs. Noncore expenses (i.e., nonoperating expenses) were the second most frequently identified reason for restatement across exempt and nonexempt companies during this period. Each of the other reasons for restatements represented less than 20 percent of all restatements by exempt and nonexempt companies during the period.

Figure 3: Reasons for Financial Restatements by Exempt Companies and Nonexempt Companies, 2005-2011



Source: GAO analysis of Audit Analytics data.

From 2005 through 2011, the majority of financial restatements by exempt and nonexempt companies negatively impacted the company's financial statements.[37] Specifically, 87.6 percent of financial restatements by exempt companies resulted in a negative net effect on the financial

[37] Audit Analytics' Restatement database includes an assessment of whether the effect on the financial statement is positive or negative.

statements—the income statement, the balance sheet, the statement of cash flows, or the statement of shareholder's equity—of these companies. Similarly, 80.6 percent of financial restatements by nonexempt companies resulted in a negative net effect on the company's financial statements.

The characteristics of exempt and nonexempt companies with financial restatements varied from 2005 through 2011. For example, in terms of industry characteristics, on average, most exempt companies restating were in the manufacturing sector (29.4 percent), followed by agriculture, construction, and mining (14.6 percent). On average, most of the nonexempt companies restating were in the manufacturing sector (29.3 percent), followed by the financial sector (16.6 percent). Further, in 2011, 91.4 percent of nonexempt companies restating compared to 35.3 percent of exempt companies were listed on an exchange.[38] In addition, nonexempt companies had an average financial restatement period that was longer than that of exempt companies.[39] Specifically, from 2005 through 2011, nonexempt companies had an average financial restatement period of 9 quarters compared to an average financial restatement period of almost 6 quarters for exempt companies.

Views on the Costs and Benefits of Auditor Attestation Vary among Companies and Others

Companies and others identified various costs of the auditor attestation requirement. A number of studies and surveys show that since the passage of the Sarbanes-Oxley Act, and especially since the 2007 reforms by SEC and PCAOB, audit costs have declined for companies of all sizes. These studies and surveys also show that these costs, as a percentage of revenues, affect smaller companies disproportionately compared to their larger counterparts. Companies and others also identified benefits of compliance, including stronger internal controls and more transparent and reliable financial reports. However, determining whether auditor attestation compliance costs outweigh the benefits is difficult because many costs and benefits cannot be readily quantified.

[38]Companies were listed on the New York Stock Exchange, Nasdaq National Market, Nasdaq Smallcap Market, American Stock Exchange, or were traded in the over-the-counter market.

[39]The financial restatement period is the accounting period (e.g., last 4 quarters) of the previously issued financial statements that contained a material inaccuracy that had to be corrected by filing revised financial statements with SEC.

Auditor Attestation Costs Can Be Significant, Especially for Small Companies, but Costs Are Declining

A number of studies and surveys show that the estimated costs of obtaining an external auditor attestation on internal control over financial reporting are significant for companies of all sizes. Obtaining an auditor attestation incurs both direct and indirect costs, according to one study.[40] Direct costs are expenses incurred to fulfill the auditor attestation requirement, such as the audit fees, external fees paid to outside contractors and vendors that help companies comply with the requirement, salaries of internal staff for hours spent preparing for auditor attestation compliance, and nonlabor expenses (e.g., technology, software, travel, and computers related to compliance). Indirect costs are those costs not directly linked to obtaining the auditor attestation. Two examples of indirect costs cited by one interviewee and one study are the time spent by management in preparing for and addressing auditors' inquiries, which diverts their attention from strategic planning, and the diversion of funds from capital investments to auditor attestation-related expenses.[41]

Audit fees are a significant direct cost of the auditor attestation requirement. Sarbanes-Oxley Act and PCAOB standards require that the financial statement audit and the auditor attestation audit be conducted on an integrated basis.[42] As a result, the auditor attestation is included in the total audit fees—that is, the total amount companies pay to their external auditors to conduct the integrated audit. Audit fees are based on several factors, including but not limited to the scope of an audit, which is a function of a company's complexity and risk; the total effort required by the external auditor to complete the audit; and the risk associated with performing the audit.[43] However, according to SEC's 2011 study and one

[40] C. R. Alexander, S. W. Bauguess, G. Bernile, Y. A. Lee, and J. Marietta-Westberg, "The Economic Effects of SOX Section 404 Compliance: A Corporate Insider Perspective," Working paper, (March 2010).

[41] Y. Jahmani and W. A. Dowling, "The Impact of Sarbanes-Oxley Act," *Journal of Business & Economics Research*, vol. 6, no. 10 (2008).

[42] Pub. L. No. 107-204, § 404(b), 116 Stat. 745, 789 (2010) (codified as amended at 15 U.S.C. § 7262); Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements* (PCAOB 2007).

[43] According to PCAOB Auditing Standard No. 8, in an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework. Auditing Standard No. 8, *Audit Risk* (PCAOB 2010).

interviewee, the costs incurred by a company to comply with the auditor attestation requirement generally decline after the initial year.

We analyzed total audit fees as a percentage of revenues from 2005 through 2011 for exempt and nonexempt companies.[44] We found that exempt companies, which tend to be smaller, had higher average total audit costs, measured as a percentage of revenues, compared to nonexempt companies (see table 5). Among exempt companies, the data indicate that exempt companies that do not voluntarily comply with the auditor attestation requirement have (except for 2006) higher average total audit fees as a percentage of revenues than the exempt companies that voluntarily comply. While two academics we contacted about this trend could not provide a definitive explanation, there are many factors beside company size that can affect audit fees.

Table 5: Average Total Audit Fees as a Percentage of Revenues, 2005-2011

	Exempt companies that did not voluntarily comply		Exempt companies that voluntarily complied		Nonexempt companies	
Year	Number of companies	Percentage	Number of companies	Percentage	Number of companies	Percentage
2005	3729	2.93%	50	1.44%	4151	1.40%
2006	2927	2.65	77	3.07	4206	1.41
2007	2370	3.14	111	1.95	4060	1.07
2008	2306	3.19	215	1.16	3967	1.11
2009	2449	3.27	393	2.98	3560	1.33
2010	2546	3.14	322	1.57	3476	0.91
2011	2227	3.41	265	1.22	3556	1.15

Source: GAO analysis of Audit Analytics data.

Note: In calculating the average audit fees as a percentage of revenues, companies in all three categories with less than $150,000 in revenue are excluded.

Our data analysis results are consistent with our previous work on audit fees. Specifically, in 2006, we reported that smaller public companies paid disproportionately higher audit fees compared to larger public

[44] SEC defines audit fees as those fees for financial statement audit and review services performed by the auditor to fulfill its responsibility under generally accepted accounting standards or to render an opinion or review report on the financial statements.

companies.[45] Smaller public companies noted that they incur higher audit fees and other costs, such as hiring more staff or paying outside consultants to comply with the internal control provisions of the Sarbanes-Oxley Act. One study noted that historically, these higher audit fees and other costs increased regulatory costs for smaller public companies because regulatory compliance, in general, involves a significant number of fixed costs regardless of the size of a company. Thus, smaller companies with lower revenues are forced to bear these fixed costs over a smaller revenue base compared to larger companies.[46]

However, the auditor attestation is one element of the total audit fees. To gauge the amount spent on the auditor attestation, we asked respondents to our survey to provide us with the amount of total audit fees and the approximate amount attributable to complying with the auditor attestation requirement. Based on our survey results, we estimate that all companies with a market capitalization of less than $10 billion that obtained an auditor attestation in 2012 spent, on average, about $350,000 for auditor attestation fees, representing about 29 percent of their average total audit fees.[47]

Although these costs remain significant for many companies, the cost of implementing the auditor attestation provision has been declining and varies by company size. For example, SEC's 2009 study on internal control over financial reporting found that, among other things, the mean auditor attestation costs declined from about $821,000 to about $584,000 (approximately 29 percent) pre- and –post 2007 reforms for all companies that obtained an auditor attestation. Median costs declined from about $358,000 to $275,000 (approximately 23 percent) pre- and –post 2007

[45]GAO, *Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, GAO-06-361 (Washington, D.C.: Apr. 13, 2006).

[46]J. L. Orcutt, "The Case Against Exempting Smaller Reporting Companies from Sarbanes-Oxley Section 404: Why Market-Based Solutions are Not Likely to Harm Ordinary Investors," *Fordham Journal of Corporate & Financial Law*, vol. 14, no. 2 (2009).

[47]The weighted estimates have margins of error of about plus or minus $71,000 and plus or minus 6 percentage points, respectively. In addition to sampling error, the weighted estimates are subject to nonsampling error in that respondents were asked to provide the approximate amount attributable to the auditor attestation requirement. See appendix I for more details.

reforms.[48] According to the study and an academic we interviewed, costs have been declining for a variety of reasons, including companies and auditors gaining experience in the auditor attestation environment and the 2007 SEC and PCAOB guidance. The academic further stated that in the early years of implementation of Section 404(b), initial costs were high for all companies, in part, because they had not previously implemented effective internal controls.[49]

Companies and Others Also Identified Perceived Benefits of Compliance

There are two types of potential benefits or positive impacts—direct and indirect—that companies can receive from complying with the auditor attestation requirement according to one study.[50] Direct benefits are those directly related to improvements in the company's financial reporting process, such as the quality of the internal control structure, the audit committee's confidence in the internal control structure, the quality of financial reporting, and the company's ability to prevent and detect fraud. Indirect benefits are other dimensions that may be affected by changes in the quality of the financial reporting process, such as a company's ability to raise capital, the liquidity of the common stock, and the confidence investors and other users of financial statements may have in the company.

[48]Securities and Exchange Commission, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements* (Washington, D.C.: September 2009).

[49]Internal control is not a new requirement for public companies. In December 1977, as a result of corporate falsification of records and improper accounting, Congress enacted the Foreign Corrupt Practices Act (FCPA). Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified at 15 U.S.C. §§ 78dd-1-78dd-3). The FCPA's internal accounting control requirements were intended to prevent fraudulent financial reporting, among other things. The FCPA amended the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78pp (2012), to require public companies to (1) make and keep books, records, and accounts that in reasonable detail accurately and fairly reflect the transactions and dispositions of assets and (2) develop and maintain a system of internal accounting controls sufficient to provide reasonable assurance that transactions are executed with management authorization and that transactions are recorded in a manner to (a) allow the preparation of financial statements in accordance with generally accepted accounting principles or other applicable criteria and (b) maintain accountability for assets. *Id.* (amending Sec. 13(b) of the Securities Exchange Act of 1934; codified at 15 U.S.C. § 78q(b)).

[50]C. R. Alexander, S. W. Bauguess, G. Bernile, Y. A. Lee, and J. Marietta-Westberg, "The Economic Effects of SOX Section 404 Compliance: A Corporate Insider Perspective," Working paper, (March 2010).

Respondents to our survey identified a number of benefits or positive impacts stemming from compliance with the auditor attestation requirement, although fewer of them perceived indirect benefits compared to direct benefits. Many survey respondents noted that they experienced a number of direct benefits. For example, we estimate that:

- 80 percent of all companies view the quality of their company's internal control structure as benefiting from the auditor attestation;
- 73 percent view their audit committee's confidence in internal control over financial reporting as benefiting from the auditor attestation;
- 53 percent view their financial reporting as benefiting from the requirement; and
- 46 percent view their ability to prevent and detect fraud as benefiting from the auditor attestation (see table 6).

Our findings are consistent with other surveys. In particular, Protiviti's 2013 survey found that, among other things, 80 percent of respondents reported that their company's internal control over financial reporting structure had improved since they began complying with the auditor attestation requirement.[51] However, we also found that, except for improved confidence in the financial reports of other Section 404(b) compliant companies, fewer companies' perceived indirect benefits of the requirement. Specifically, based on our survey results, no more than 30 percent of all companies with less than $10 billion in market capitalization perceived any of the identified indirect benefits (see table 6) as stemming from the auditor attestation requirement.

[51]Protiviti, *2013 Sarbanes-Oxley Compliance Survey: Building Value in Your SOX Compliance Program*. 2013.

Table 6: Estimated Percentage of Companies with Market Capitalization Less Than $10 Billion That Perceive Benefits from the Auditor Attestation, by Type of Benefit

Type of benefit	Percentage
Direct benefits:	
Quality of company's internal control structure	80%
Audit committee's confidence in company's internal control over financial reporting	73
Quality of company's financial reporting	53
Ability to prevent and detect fraud	46
Indirect benefits:	
Company's ability to raise capital	16
Investor confidence in company	30
Efficiency of company's operation	19
Efficiency of company's financial reporting process	19
Liquidity of company's common stock	7
Timeliness of company's financial statement audit	11
Company's overall value	16
Confidence in the financial reports of other 404(b) compliant companies	52

Source: GAO survey.

Note: The percentage estimates have a margin of error of plus or minus 15 percentage points or fewer.

A 2013 study conducted by one academic we interviewed examined the earnings quality—how well earnings reflect actual firm performance—of exempt companies and nonexempt companies.[52] The study found a significant deterioration in the quality of earnings for exempt companies, but not for nonexempt companies.[53] In addition, SEC in its 2009 study on

[52]A. D. Holder, K. E. Karim, and A. Robin, "Was Dodd-Frank Justified in Exempting Small Firms from Section 404b Compliance?" *Accounting Horizons*, vol. 27 no. 1 (March 2013). There is no single definition of the term "earnings quality."

[53]Two other studies looking at the effect of auditor attestation on exempt and small nonexempt companies had similar findings: one found that compliance with auditor attestation had improved the quality of financial reporting as measured by materially misstated financial statements (see Nagy, "Section 404 Compliance and Financial Reporting Quality," *Accounting Horizons*, vol. 24, no. 3 (2010), while the other found that auditor attestation benefits small companies via higher revenue quality as measured by discretionary (abnormal) revenues (see G. V. Krishnan and W. Yu, "Do Small Firms Benefit from Auditor Attestation of Internal Control Effectiveness?" *Auditing: A Journal of Practice and Theory*, vol. 31 no. 4 (2012)).

auditors' involvement in internal control over financial reporting noted the following benefits: (1) the independent auditor's assessment of the effectiveness of a company's internal controls results in a more disciplined management assessment process; (2) the independent auditor's expertise can provide management with an additional perspective on the quality of the company's internal controls; and (3) the independent audit of a company's internal controls improves the reliability of a company's internal control disclosures and financial reports. According to some academic researchers, obtaining an auditor attestation can also have a positive impact on a company's cost of capital. One academic we interviewed noted that by complying with the auditor attestation requirement small companies incur lower borrowing costs and therefore a lower cost of capital because investors have greater trust in the accuracy of the companies' financial reporting. Another academic we interviewed noted that companies that do not comply with Section 404(b) of the Sarbanes-Oxley Act reduce investors' confidence in the companies and reduce the transparency and reliability of companies' financial filings. As a result, he would expect their cost of capital to increase. In addition, as discussed later in the report, a 2013 study empirically supports the view that companies that voluntarily comply with the auditor attestation have lower cost of capital.[54]

Measuring the Costs and Benefits of the Auditor Attestation Requirement Is Difficult, and Views Differ on Whether Benefits Exceed Costs

Measuring both the costs and benefits of the auditor attestation requirement is difficult. According several studies, direct costs, such as audit fees, are tangible and immediate and therefore are more readily measured. Indirect costs, such as opportunity costs, are more difficult to measure because they are less tangible. In comparison, however, benefits are more difficult to identify, measure, and quantify than costs because they are intangible and may occur over a longer period.[55] Because measuring the costs and benefits of auditor attestation is difficult, comparing costs and benefits is also challenging.

[54] C. A. Cassell, L.A. Myers, and J. Zhou, "The Effects of Voluntary Internal Control Audits on the Cost of Capital," Working paper, (Feb. 13, 2013).

[55] Y. Jahmani and W. A. Dowling, "The Impact of Sarbanes-Oxley Act," *Journal of Business & Economics Research*, vol. 6, no. 10 (2008); Coates IV, John C. "The Goals and Promise of the Sarbanes-Oxley Act," *Journal of Economic Perspectives*, vol. 21, no. 1 (2007); and Chief Financial Officers' Council and the President's Council on Integrity and Efficiency. "Estimating the Costs and Benefits of Rendering an Opinion on Internal Control over Financial Reporting."

Our survey results indicate that the views on whether the benefits associated with auditor attestation compliance outweigh the costs are mixed. According to our survey results, we estimate that about 57 percent of all companies with less than $10 billion in market capitalization view the costs as somewhat or greatly outweighing the benefits; 16 percent of the companies view the benefits as somewhat or greatly outweighing costs; 21 percent of the companies view costs and benefits as being about equal; and 6 percent are not sure. Generally, the perceptions were consistent across companies of different sizes.[56] Some of the reasons companies gave for their views include that the costs are particularly onerous for smaller companies, the time and effort devoted to 404 divert resources away from more value-added activities, and that the attestation overemphasizes testing and the number of controls that are necessary. Some of the reasons companies gave to support the view that the benefits outweigh the costs include that the attestation leads to improved internal control over financial reporting process, increases investor confidence in company's financial reports, and makes it easier to detect fraud.

Companies, trade associations, industry experts, and academics we interviewed expressed various views on the cost-benefit ratio of the auditor attestation. Companies generally assess the costs and benefits of auditor attestation as it relates to themselves and not the marketplace. For example, chief financial officers of two exempt companies that previously had obtained auditor attestations stated that the costs of compliance outweighed the benefits because of the money and time that they (and companies in general) spent on obtaining auditor attestation and the lack of benefits gained from such attestation. In addition, a 2010 empirical study looking at companies of comparable size with public float between $50 million and $100 million found that the net effect of auditor attestation (as measured by stock returns) was negative.[57] The reduction in the market value of nonexempt companies suggests that the costs of

[56]For exempt companies that voluntarily complied with the auditor attestation requirement, 63 percent view the costs as somewhat or greatly outweighing the benefits; 19 percent view the benefits as somewhat or greatly outweighing costs; 15 percent view costs and benefits as being about equal; and 3 percent are not sure. For nonexempt companies, 57 percent view the costs as somewhat or greatly outweighing the benefits; 15 percent view the benefits as somewhat or greatly outweighing costs; 21 percent view costs and benefits as being about equal; and 7 percent are not sure.

[57]P. Iliev, "The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices," *Journal of Finance*, vol. 65, no. 3 (2010).

compliance may outweigh the benefits for small companies. In contrast, trade associations, industry experts, and some academics we interviewed generally view the benefits as outweighing the costs. They stated generally that even though the auditor attestation is costly to obtain, it has led to more reliable financial reporting, greater transparency and investor protections, or improved internal control systems. SEC and PCAOB officials noted that their agencies have not taken an official position regarding whether the benefits of a company obtaining an auditor attestation outweigh the costs.

Other survey results also show mixed views on whether the benefits associated with auditor attestation compliance outweigh the costs. A 2012 survey of financial, compliance, internal audit, and other executives examined issues companies must address related to the Sarbanes-Oxley Act. The survey results show that even though initial costs and efforts to comply with Section 404 were burdensome, many companies (31 percent of respondents) viewed the benefits as outweighing the costs, in part due to improvement in internal controls.[58] Fifty percent of all responding companies viewed the costs as outweighing the benefits to some degree, and 19 percent viewed the costs and benefits as equal. Large companies held a slightly more positive view of the benefits than small companies. Another 2012 annual survey that looked at audit fees found that 51 percent of the companies that complied with the auditor attestation requirement thought that they had better internal controls as a result and that the attestation was worth the expense.[59] Thirty-seven percent of respondents thought they had better internal controls but that this benefit was not worth the expense, and 7 percent thought that the cost of compliance far exceeded any additional improvement to internal controls. In comparison, the 2005 annual survey showed that during the early implementation of Section 404(b) of Sarbanes-Oxley Act, over 90 percent of survey respondents said that the costs outweighed the benefits.[60]

[58]Protiviti, *2012 Sarbanes-Oxley Compliance Survey: Where U.S.-Listed Companies Stand – Reviewing Cost, Time, Effort and Process.* 2012.

[59]Financial Executives International and Financial Executives Research Foundation, *2012 Audit Fee Survey* (Morristown, N.J.: 2012). Financial Executives International is a trade group for financial executives.

[60]Financial Executives International and Financial Executives Research Foundation, *Special Survey on Sarbanes-Oxley Section 404 Implementation* (Morristown, N.J.: 2005).

Auditor Attestations Appear to Positively Affect Investor Confidence, and Disclosure of Compliance Status Could Enhance Investor Protection

Research suggests that auditor attestation generally has a positive effect on investor confidence. Although exempt companies are currently not required to disclose whether they voluntarily complied with the auditor attestation requirement in their annual reports, doing so would provide investors with important information that may influence their investment decisions.

Most Empirical Studies We Reviewed Suggest That Auditor Attestation Has a Positive Impact on Investor Confidence

Recent empirical studies we reviewed found that auditor attestation of internal controls generally has a positive impact on investor confidence. Investor confidence is considered an indirect benefit to companies that comply with the auditor attestation requirement. Specifically, an auditor attestation of internal controls helps to reduce information asymmetries between a company's management and investors.[61] With increased transparency and better financial reporting due to reliable third-party attestation, investors face a lower risk of losses from fraud. This lowered risk has a number of positive consequences for companies, such as enabling them to pay less for the capital as more confident investors require a lower rate of return on their money.

Because investor confidence is difficult to measure directly, empirical research has examined the impact of auditor attestation on other variables that are considered proxies for investor confidence, including the cost of equity and debt capital, stock performance, and liquidity.[62] As

[61]Information asymmetry refers to the fact that managers of a company typically know more than outsiders about the conditions of the company and its future prospects. They can exploit this information asymmetry to help the company or themselves by, for example, releasing limited or biased information. These actions would affect the ability of investors to make good investment decisions and in turn lead to inefficiencies, such as misallocation of capital.

[62]Our focus in this section is on recent empirical research about the impact on investor confidence of auditor attestations required by the Sarbanes-Oxley Act's Section 404(b). There is a large body of empirical research that has investigated different aspects of the implementation of the Sarbanes-Oxley Act's Sections 302, 404(a), and 404(b) since the passage of the act. See A. Schneider, A. Gramling, D. R. Hermanson and Z. Ye, "A Review of Academic Literature on Internal Control Reporting Under SOX," *Journal of Accounting Literature*, vol. 28 (2009).

described below, such research has found that the auditor attestation increases investor confidence.

- A 2012 study examined exempt and nonexempt companies with market capitalization between $25 million and $125 million. This study found that the market value of equity—as measured by the common stock price—is positively associated with the book value of equity—which is an element in financial statements—but that this relationship is stronger for nonexempt companies.[63] In other words, investors appear to put greater trust on the book value of equity of companies that are subject to auditor attestation compared to those companies that are not. As a result, book value is more likely to have a positive effect on market value if the auditor attestation is present. These results are consistent with the notion that the auditor attestation provides useful and relevant information to investors.

- A 2013 study found that exempt companies that voluntarily comply with the auditor attestation enjoy a lower cost of capital. Specifically, both the cost of equity and the cost of debt are significantly lower for companies that voluntarily comply with the requirement compared to those exempt companies that do not.[64] These results are consistent with the view that auditor attestation leads to higher investor confidence and that voluntary compliance with the requirement reduces the risk companies present to investors. This lowered risk, in turn, reduces the risk premium that investors demand to hold these companies' stocks or bonds.

- A 2012 study examined the equity market response to the 2009 proposed permanent exemption from the auditor attestation requirement for public companies with a public float of less than

[63]G. V. Krishnan and W. Yu, "Do Small Firms Benefit from Auditor Attestation of Internal Control Effectiveness?" *Auditing: A Journal of Practice and Theory*, vol. 34, no.1 (2012).

[64]C. A. Cassell, L.A. Myers, and J. Zhou, "The Effects of Voluntary Internal Control Audits on the Cost of Capital," Working paper, (Feb. 13, 2013).

75 million.[65] The study found a negative market response to the exemption but less so for those companies that voluntarily complied before 2009. It also found that to reduce information asymmetry, companies that voluntarily comply use their compliance as a signal to the marketplace of the superior quality of their financial reporting—a signal that is credible because it is costly and difficult to imitate by companies with weak internal controls.[66] Also, companies that voluntarily complied with auditor attestation had significant increases in liquidity.[67]

Other research supports the view that auditor attestation of internal control effectiveness matters for investors and other market participants insofar as adverse auditor reports have negative consequences for companies. Such consequences include higher cost of debt (and possibly

[65]More specifically, the study undertakes an empirical investigation of the response to the November 2009 Garrett-Adler amendment approved by the House Financial Services Committee, which proposed to exempt smaller public companies from the auditor attestation requirement. (*see* Investor Protection Act of 2009, H.R. 3817, 111th Cong. § 606). K. Brown, P. Pacharn, J. Li, E. Mohammad, F. A. Elayan, and F. Chu, "The Valuation Effect and Motivations of Voluntary Compliance with Auditor's Attestation under Sarbanes-Oxley Act Section 404 (B)," Working paper, (Jan. 15, 2012).

[66]Signaling may provide a benefit especially to small, high-growth companies that need capital to expand. Exempt companies have to balance the potential benefits and cost of voluntary compliance, as auditors' involvement increases the likelihood that internal control deficiencies will be discovered and disclosed, with negative consequences.

[67]This increase suggests that auditor attestation enhances public confidence in financial reports leading to a flight to quality by investors and an increase in liquidity, in which investors move their capital away from assets perceived as risky in favor of those viewed as safer.

higher cost of equity), lower probability that lenders will extend lines of credit, stricter loan terms, and unfavorable stock recommendations.[68]

While most research findings we reviewed suggest auditor attestation provides valuable information to investors and has a positive effect on confidence, a 2011 study questions the value of the auditor attestation for small companies.[69] Looking at exempt and small nonexempt companies with market capitalization of $300 million or less, the study finds that small companies that became nonexempt, and therefore subject to the auditor attestation requirement, in 2004 experienced a statistically significant increase in their material weakness disclosure rate, but companies that remained exempt saw similar increases through their management reports under Section 404(a) of the Sarbanes-Oxley Act. The results suggest that auditor attestation provides little additional information to investors in terms of detecting material weaknesses because there is no statistically significant difference in the rate of disclosure of material weakness between the two types of companies.

Anecdotal Information Also Suggests Auditor Attestation Can Positively Impact Investor Confidence

The majority of academics and market participants we interviewed suggest that having auditor attestation positively impacts investor confidence. Specifically, they told us that the involvement of auditors in attesting to the effectiveness of internal controls improves the reliability of the financial reporting and serves to protect investors. As a result, they said, the exemption granted to small companies is likely to reduce investor confidence because these companies already have greater

[68]See for example, A. Crabtree and J. J. Maher, "Credit Ratings, Cost of Debt, and Internal Control Disclosures: A Comparison of SOC 302 and SOX 404," *The Journal of Applied Business Research*, vol. 28, no. 5, (2012); J.B. Kim, B.Y. Song, L. Zhang, "Internal Control Weakness and Bank Loan Contracting: Evidence from SOX Section 404 Disclosures," *The Accounting Review*, vol. 86, no. 4 (2011); D. Dhaliwal, C. Hogan, R. Trezevant, and M. Wilkins, "Internal Control Disclosures, Monitoring, and the Cost of Debt," *The Accounting Review*, vol. 86, no. 4 (2011); H. Ashbaugh-Skaife, D. Collins, W. Kinney, and R. LaFond, "The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity," *Journal of Accounting Research*, vol. 47, no. 1 (2009); A. Schneider and B.K. Church, "The Effect of Auditors' Internal Control Opinions on Loan Decisions," *Journal of Accounting and Public Policy*, vol. 27, no.1 (2008); S. K. Asare and A. Wright, "The Effect of Type of Internal Control Report on Users' Confidence in the Accompanying Financial Statement Audit Report," *Contemporary Accounting Research*, vol. 29, no. 1 (2012).

[69]W. R. Kinney and M. L. Shepardson, "Do Control Effectiveness Disclosures Require SOX 404(b) Internal Control Audits? A Natural Experiment with Small U.S. Public Companies," *Journal of Accounting Research*, vol. 49, no. 2. (2011).

informational asymmetry. They said that according to academic and other studies, small companies are also more likely than large ones to have serious internal control problems. Furthermore, they commented that management's report on internal controls alone is often uninformative because management often fails to detect internal control deficiencies or classifies them as less severe than they are. Some market participants also told us that any company accessing capital markets, regardless of size, should be required to comply with the auditor attestation requirement as investors in any company, large or small, are entitled to the same investor protection.

Our survey results also indicate that some companies view auditor attestation as contributing to investor confidence, which is similar to findings from others' studies and surveys. Our survey results show that the majority of respondents are more confident in the financial reports of companies that comply with the auditor attestation requirement than companies that do not. In addition, we estimate that 30 percent of responding nonexempt and exempt companies that voluntarily comply thought that the requirement increased investor confidence in their own company, while 20 percent were not sure and the remaining 50 percent reported no impact. This perspective is consistent with the results from an in-depth 2009 telephone survey SEC conducted of a small group of financial statement users—such as lenders, securities analysts, credit rating agencies, and other investors—regarding their views on the benefits of auditor attestation. These SEC survey respondents indicated that the auditor's attestation report provides additional benefits to users and other investors beyond the management's report under Section 404(a) and that the requirement generally has a positive impact on their confidence in companies' financial reports. Moreover, in response to a 2010 Center for Audit Quality (CAQ) survey of individual investors, almost two-thirds of investors said they were concerned about exempting companies with annual revenues of under $75 million from the independent auditor attestation requirement, suggesting that the requirement has a positive effect on individual investors' confidence in the financial information generated by smaller companies.[70] Similarly, in a

[70]Center for Audit Quality, *The CAQ's Fourth Annual Individual Investor Survey*, September 2010. The Center for Audit Quality is a nonprofit group whose board includes leaders from the public company auditing firms, the American Institute of CPAs, and three members from outside the public company auditing profession. The organization is affiliated with the American Institute of CPAs and seeks to enhance investor confidence and public trust in the global capital markets.

2012 survey of investors conducted by the PCAOB Investor Advisory Group on the role, relevance, and value of the audit, over 60 percent of respondents said that the auditor's opinion on the effectiveness of internal controls is critical in making investment decisions.[71] Further, in a 2012 survey of individual investors by CAQ, 70 percent of the respondents identified independent audits in general as the most effective means of protecting their interests.[72]

Disclosure of Auditor Attestation Status Could Enhance Transparency

Explicit disclosure of auditor attestation status in exempt companies' annual reports could quickly provide investors useful information that may influence their investment decisions. Currently, exempt companies are not required to disclose in their annual reports whether they have voluntarily obtained an auditor attestation on their internal controls. From 2005 through 2010, SEC granted small public companies multiple extensions from having to comply with the auditor attestation requirement. During this time of forbearance, SEC required exempt companies to include a general statement in their annual report that the company was not required to comply with the auditor attestation requirement because of SEC's grant of temporary exemption status. According to SEC officials, the statement served to provide investors who may have been looking for the attestation an explanation of its absence. SEC granted its final temporary exemption to take effect on June 15, 2010, prior to the passage of the Dodd-Frank Act. SEC did not require exempt companies to include the disclosure statement when implementing the provision of the Dodd-Frank Act that created the permanent exemption.

SEC officials said that it is not common for the agency to require a company to disclose compliance status for requirements that are not applicable to the company—which, according to SEC officials, could potentially influence a company's behavior. Further, SEC officials noted that information on the company's filing status—and, therefore exemption status—can be found in the company's annual reports and other

[71]In addition, about 47 percent of respondents reported using the auditor's report "always" or "often" when making investment decisions, with about 27 percent reporting using it "sometimes." PCAOB Investor Advisory Group, March 28, 2012, presentation on the Role, Relevance, and Value of the Audit.

[72]Center for Audit Quality, *The CAQ's Sixth Annual Main Street Investor Survey*, September 2012.

documents, which are available to all investors.[73] Therefore, SEC officials stated that such information allows investors to determine whether an attestation has been obtained. However, while this information is available, a company's attestation status is not readily apparent without some knowledge or interpretation of the current reporting requirements. As noted earlier, SEC has previously required companies to provide additional clarity on their compliance with the auditor attestation requirement. Thus, requiring companies to explicitly disclose their auditor attestation status would be consistent with its past action.

Further, federal securities laws require public companies to disclose relevant information to investors to aid them in their investment decisions.[74] Many market participants we interviewed consider the external auditor's assessment of the effectiveness of a company's internal control over financial reporting to be important information for investors. Thus, many market participants we interviewed and companies we surveyed noted that exempt companies should be required to explicitly disclose whether or not they obtained an auditor attestation to make the information more transparent for investors. In particular, according to the results of our survey, we estimate that 57 percent of all companies with less than $10 billion in market capitalization are in favor of requiring exempt companies to disclose whether they have voluntarily obtained an auditor attestation. A representative from one company said "I believe there is an assumption that SEC-listed companies are in compliance with 404. If companies are not, they should disclose such." A representative from another company said that "If investors value the independent audit, then they should be made aware of situations where such audit has not been performed. Investors should not have to interpret the regulations to know if the audit is required." Some companies we surveyed that were not in favor of such disclosure generally believed that investors can get the information from the audit opinion in the annual report. As of year-end 2011, approximately 300 exempt companies had voluntarily complied with the auditor attestation requirement. Although information on voluntary compliance with the auditor attestation requirement is determinable, having the information explicitly disclosed could benefit investors. Such

[73] See for example, Items 8 and 9A in the annual reports filed with SEC and Item 308(a)(4) of Regulation S-K, as amended in 2010.

[74] See *generally* Securities Act of 1933, §§ 7, 8, 11, 12, and 17; Securities Exchange Act of 1934, §§ 10, 13, and 14.

disclosure would increase transparency and investor protection by making investors more aware of this important investment information.

Conclusions

Investors need accurate financial information with which to make informed investment decisions, and effective internal controls are necessary for accurate and reliable financial reporting. The attestation requirement is part of legislation aimed at helping to protect investors by, among other things, improving the quality of corporate financial reporting and disclosures. Perceptions of the costs and benefits of auditor attestation continue to vary among companies and others, but among other benefits, obtaining auditor attestation appears to have a positive impact on investor confidence. In addition, our analysis found that companies (both exempt and nonexempt) that obtained an auditor attestation generally had fewer financial restatements than those that did not, which suggests that knowing whether a company has obtained the auditor attestation may be useful for investors in gauging the reliability of a company's financial reporting. However, because SEC regulations currently do not require explicit statements regarding the voluntary attainment of auditor attestation, investors may have to interpret reporting requirements and filings to determine whether exempt companies have obtained an auditor attestation. Previously, when certain companies were temporarily exempt from the auditor attestation requirement, SEC required explicit disclosure of exemption status in companies' annual reports. However, SEC eliminated this requirement in 2010 when companies of certain sizes were permanently exempted. Federal securities laws require public companies to disclose relevant information to investors to aid them in their investment decisions. Although information on a company's exempt status is available to investors, explicit disclosure would increase transparency and investor protection by making investors readily aware of whether a company has obtained an auditor attestation on internal controls. The disclosure could serve as an important indicator of the reliability of a company's financial reporting, which may influence investors' decisions.

Recommendation for Executive Action

To enhance transparency and investor protection, we recommend that SEC consider requiring public companies, where applicable, to explicitly disclose whether they obtained an auditor attestation of their internal controls.

Agency and Third-Party Comments and Our Evaluation

We provided a draft of the report to the SEC Chairman for her review and comment. SEC provided written comments that are summarized below and reprinted in appendix II. We also provided a draft of the report to PCAOB and relevant excerpts of the draft report to Audit Analytics for technical review. We received technical comments from SEC, PCAOB, and Audit Analytics that were incorporated as appropriate.

In its written comments, SEC did not comment on our recommendation that it consider requiring public companies to explicitly disclose whether they have obtained an internal control attestation. Rather, SEC confirmed, as described in the draft report, that a nonaccelerated filer (referred to as an exempt company in our report) does not have to explicitly disclose whether it obtained an auditor attestation report on its internal controls in its annual report. However, SEC stated that this fact can be easily determined by investors from information that is already disclosed in the annual report. In addition, SEC stated that investors can also find information regarding the existence of an opinion on internal controls by looking at the audit report in the company's filing. SEC also noted that PCAOB standards permit an auditor that is not engaged to opine on internal controls to include a statement in its report on the financial statements indicating that it is not opining on the internal controls. In our report, we acknowledge that information needed to determine a company's auditor attestation status is available. However, because an explicit statement on the company's status is not required, investors must deduce the company's status from the available information. Explicit disclosure could significantly decrease the potential for investors to misinterpret the information regarding a company's audit attestation status. Such disclosure would increase transparency and investor protection by making investors readily aware of this important investment information. We therefore maintain that the disclosure warrants further consideration by SEC.

We are sending copies of this report to appropriate congressional committees, SEC, PCAOB, Audit Analytics and other interested parties. In addition, the report is available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or clowersa@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix IV.

A. Nicole Clowers
Director
Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

This report discusses: (1) how the number of financial statement restatements compares between exempt and nonexempt companies; (2) the costs and benefits for nonexempt companies as well as exempt companies that voluntarily comply with the auditor attestation requirement; and (3) what is known about the extent to which investor confidence in the integrity of financial statements is affected by whether or not companies comply with the auditor attestation requirement. We define exempt companies as those with less than $75 million in public float (nonaccelerated filers) and nonexempt companies as those with $75 million or more in public float (accelerated filers). For the purposes of this report, we define exempt companies as those with less than $75 million in public float (nonaccelerated filers) and nonexempt companies as those with $75 million or more in public float (accelerated filers).

To address all three objectives, we reviewed and analyzed information from a variety of sources, including the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), relevant regulatory press releases and related public comment letters, and available research studies.[1] We also interviewed officials from the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB), and we interviewed chief financial officers of small public companies, representatives of relevant trade associations (representing individual and institutional investors, accounting companies, financial analysts and investment professionals, and financial executives), a large pension fund, a credit rating agency, academics knowledgeable about accounting issues, and industry experts.

Comparison of Exempt and Nonexempt Financial Restatements

To determine the number of financial statement restatements (referred to as financial restatements) and trends, we analyzed data from the Audit Analytics database from 2005 through 2011.[2] We used the Audit Analytics' Auditor Opinion database to generate the population of exempt

[1] Pub. L. No. 107-204, 116 Stat. 745 (2002); Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] Audit Analytics is an online market intelligence service that provides information on SEC registrants. Audit Analytics maintains a proprietary database containing information from the filings public companies submit to SEC, such as audit fees, audit opinions, and financial restatements.

and nonexempt companies in each year from 2005 through 2011.[3] Our analysis does not include 2012 data because 2012 small-company data was incomplete. According to Audit Analytics, the incomplete data was often due to the fact that small companies had not yet filed the relevant information with SEC. The sample we used to produce the population of exempt and nonexempt companies does not include subsidiaries of a public company, registered investment companies, or asset-backed securities issuers. Once we excluded these companies from the entire population, we grouped the remaining companies based on their filing status (i.e., nonaccelerated filer, smaller reporting company, accelerated filer, large accelerated filer, and filers that did not disclose their filing status).[4] Exempt companies are nonaccelerated filers, including smaller reporting companies. For our purposes, we grouped companies that did not disclose their filing status but whose market capitalization was less than $75 million with exempt companies.[5] We also identified for each year from 2005 through 2011 exempt companies that voluntarily complied with the integrated audit requirement as indicated in the data. Nonexempt companies are accelerated filers and large accelerated filers. For our purposes, we grouped companies that did not disclose their filing status but whose market capitalization was equal to or greater than $75 million with nonexempt companies. We excluded companies that did not disclose their filing status and did not have a reported market capitalization.

We then used Audit Analytics' Restatement database, which contains company information (e.g., assets, revenues, restatements, market capitalization, location, and industry classification code) to identify the

[3]The Audit Opinion data set covers all SEC registrants who have disclosed their auditor's report on the audit of the financial statements in electronic filings and represents the data concerning the auditor's opinion.

[4]The designation of "Large Accelerated Filer" was not approved by SEC until December 2005, and the designation of "Smaller Reporting Company" was not approved by SEC until January 2008. See Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports, 70 Fed. Reg. 76626 (Dec. 27, 2005); Smaller Reporting Company Regulatory Relief and Simplification, 73 Fed. Reg. 934 (Jan. 4, 2008).

[5]Companies that did not disclose their filing status include Canadian Form 40-F filers and others. We used market capitalization because Audit Analytics database does not capture companies' public float. Market capitalization is defined as the total dollar market value of all of a company's outstanding shares and is calculated by multiplying the number of a company's outstanding shares by the current market price of one share. Public float is a subset of market capitalization. SEC defines public float as the worldwide aggregate market value of voting and nonvoting common equity held by nonaffiliates of the filer. *See* 12 C.F.R. § 240.12b-2.

number of financial restatements from 2005 through 2011 based on our population of exempt companies, exempt companies that voluntarily complied, and nonexempt companies. Using this database, we identified 6,436 financial restatements by 4,536 public companies, 2,834 of which were exempt companies. We used Audit Analytics' 69 classifications to classify the type of financial restatements into six categories: core expenses (i.e., ongoing operating expenses), noncore expenses (i.e., nonoperating or nonrecurring expenses), revenue recognition (i.e., improperly record revenues), reclassifications and disclosures, underlying events (i.e., accounting for mergers and acquisitions), and other.[6] The majority of restatements we classified were the result of an accounting rule misapplication.[7] To identify audit costs of compliance, we analyzed data from Audit Analytics' Auditor Opinion database, which contains auditors' report information such as audit fees, nonaudit fees, auditor name, audit opinions, revenues, and company size, among other information from 2005 through 2011. Our analyses of audit costs do not include 2012 data because 2012 small-company data was incomplete. The incomplete data was often due to the fact that small companies had not yet filed the relevant information with SEC. We tested a sample of the Audit Analytics database information and found it to be reliable for our purposes. For example, we cross-checked random samples from each of Audit Analytics' databases with information on financial restatements, filing status, and internal controls from SEC's Electronic Data Gathering, Analysis, and Retrieval system. We also spoke with other users of Audit Analytics data as well as Audit Analytics officials. In addition, we reviewed relevant research studies and papers on the impact of compliance with the internal control audits on financial restatements. We consider the information to be reliable for our purpose of determining financial statement restatement trends and audit fee calculations.

[6]Five of the six categories are based on the classification scheme developed by academics Zoe-Vonna Palmrose and Susan Scholz. The "other" category was developed by GAO and comprises financial restatements that were not included in one of the other categories.

[7]The Audit Analytics Restatement database uses a taxonomy to group restatements into three categories (1) restatements based on accounting rule misapplication failure (i.e., generally accepted accounting principles); (2) restatements based on financial fraud, irregularities, and misrepresentations; and (3) restatements based on accounting and clerical errors. The database includes a fourth category to identify significant additional issues in the restatement (i.e., material weakness or loan covenant violation).

Costs and Benefits of Auditor Attestation Compliance

To examine the characteristics of publicly traded companies that complied, either voluntarily or because required, with the requirement to obtain an independent auditor attestation of their internal controls, we conducted a web-based survey of companies that had either voluntarily complied or were required to comply with the integrated audit requirement in any year between 2004 and 2011. Based on a list of publicly traded companies obtained from Audit Analytics, we identified 4,053 companies that had either voluntarily complied with the integrated audit requirement in any year from 2004 through 2011 or that were required to comply in 2011 as determined by their filing status.[8] We stratified the population into three strata by first identifying the nonaccelerated voluntary filers. These are companies that voluntarily complied with the integrated audit requirement in any year from 2004 through 2011. Since our primary focus was on the nonaccelerated voluntary filers, we selected all 392 of these companies.[9] From the remaining companies in the population, we created two additional strata based on 2011 filing status, and we took a random sample of companies from the remaining strata. The sample sizes for the remaining strata were determined to produce a proportion estimate within each stratum that would achieve a precision of plus or minus 10 percentage points or less, at the 95 percent confidence level. Finally, we increased the sample size based on the expected response rate of 40 percent. We submitted our survey to a total of 850 companies from the original population of 4,053.

We identified 104 companies in our sample that were closed, merged with another company, or improperly included in the sampling frame. We received valid responses from 195 out of the remaining 746 sampled companies (see table 7). The weighted response rate, which accounts for the differential sampling fractions within strata, is 25 percent.

[8]In this report, we use Audit Analytics data, which are based on public filings made with SEC, to develop the population for our survey. SEC uses public float to determine companies' filing status as of the companies' most recently completed second fiscal quarter. To account for changes that could occur with regard to the companies' filing status as of their recently completed second fiscal quarter and the end of the year, we filtered the populations by market capitalization because public float data were not available in the Audit Analytics database.

[9]This figure was based on the unique number of exempt firms who voluntarily complied with the requirement from 2004 through 2011 based on their filing status and market capitalization rate greater than zero and less than $75 million.

Table 7: Survey Sample Disposition

Stratum	Population size	Sample size	Out of scope	Respondents
1. Nonaccelerated voluntary filers	392	392	92	93
2. Accelerated filers	1,620	228	9	56
3. Large accelerated filers	2,041	230	3	46
Total	**4,053**	**850**	**104**	**195**

Source: GAO.

We conducted this survey in a web-based format. The questionnaire was designed by a GAO survey specialist in collaboration with GAO staff with subject-matter expertise. The questionnaire was also reviewed by experts at SEC. We pretested drafts of our questionnaire with three public companies of different sizes to ensure that the questions and response categories were clear, that terminology was used correctly, and that the questions did not place an undue burden on the respondents. The pretests were conducted by telephone with company financial executives in Iowa, Virginia, and Washington, D.C. Pretests included GAO methodologists and GAO subject-matter experts. Based on the feedback received from the pretests, we made changes to the content and format of some survey questions. We directed our survey to the chief executive officer, chief financial officer, or chief accounting officer, whose names and email addresses we obtained from Nexis. We activated our web-based survey on December 17, 2012, and closed the survey on February 19, 2013. We sent follow-up emails on three occasions to remind respondents to complete the survey and conducted telephone follow-ups to increase the response rate.

Because our survey was based on a random sample of the population, it is subject to sampling errors. In addition, the practical difficulties of conducting any survey may introduce nonsampling errors. For example, difference in how a particular question is interpreted or the sources of information available to respondents may introduce errors. We took steps, such as those described above, to minimize such nonsampling errors in the development of the questionnaire and the data collection and data analysis stages as well. For example, because this was a web-based survey, respondents entered their responses directly into the database, reducing the possibility of data-entry error. Finally, when the data were analyzed, a second independent analyst reviewed all computer programs. We conducted an analysis of our survey results to identify potential sources of nonresponse bias using two methods. First, we examined the response propensity of the sampled companies by several demographic characteristics. These characteristics included market capitalization size categories, region, and sector. Our second method consisted of comparing weighted estimates from respondents and nonrespondents to known population values for total market capitalization. We conducted statistical tests of differences, at the 95 percent confidence level, between estimates and known population values, and between respondents and nonrespondents. We determined that there was significant bias induced by the largest companies (measured by market capitalization) not responding to the survey. In other words, we found that companies with market capitalization over $10 billion were underrepresented in our sample. However, we found no evidence of substantial nonresponse bias based on these characteristics when generalizing to the population of companies with market capitalization less than or equal to $10 billion. Therefore, we adjusted the scope of our survey to include only those companies with market capitalization of less than or equal to $10 billion (see table 8).

Table 8: Sample Disposition for Adjusted Target Population

Stratum	Population size	Sample size	Out of scope	Respondents
1. Nonaccelerated voluntary filers	392	392	92	93
2. Accelerated filers	1,620	228	9	56
3. Large accelerated filers	1,585	176	1	43
Total	**3,597**	**796**	**102**	**192**

Source: GAO.

Because we found no evidence of substantial nonresponse bias when generalizing to the adjusted target population and the weighted response rate of 25 percent, we determined that weighted estimates generated from these survey results are generalizable to the population of in-scope companies.[10] We generated weighted estimates and generalized the

[10]In-scope population refers to the population to which we are generalizing that includes all publically traded companies with a public float value of less than $75 million that voluntarily complied with the integrated audit requirement in any year from 2004 through 2011 as well as those public companies with a market capitalization under $10 billion that were required to comply in 2011 and that remained in business at the time of the survey.

results to the estimated in-scope population of 3,432 companies (plus or minus 42 companies).[11]

Because we followed a probability procedure based on random selections, our sample is only one of a large number of samples that we might have drawn. Since each sample could have provided different estimates, we express our confidence in the precision of our particular sample's results as a 95 percent confidence interval. This is the interval that would contain the actual population value for 95 percent of the samples we could have drawn. As a result, we are 95 percent confident that each of the confidence intervals in this report includes the true values in the study population. All percentage estimates presented in this report have a margin of error of plus or minus 15 percentage points or fewer, and all estimates of averages have a relative margin of error of plus or minus 20 percent or less, unless otherwise noted.

To obtain information on the impact of obtaining an auditor attestation on a company's cost of capital, we included questions in our web-based survey to large and small public companies of various industries about this matter, interviewed trade associations, industry experts, a large pension fund, and academics; and reviewed relevant academic and SEC research studies.

Investor Confidence and Integrity of Financial Statements

To examine the extent to which investor confidence in the integrity of financial statements is affected by companies' compliance with the auditor attestation requirement, we reviewed relevant empirical literature written by academic researchers, as well as recent surveys, studies, reports, and articles by others. To identify these studies, we asked for recommendations from academics, SEC, PCAOB, and representatives of organizations that address issues related to the auditor attestation requirement. We reviewed bibliographies of papers we obtained to identify additional material. In addition, we conducted searches of online databases such as ProQuest and Nexis using keywords to link Section 404(b) of the Sarbanes-Oxley Act with investor confidence. We also conducted interviews with agencies and organizations, as well as

[11]Since we were able to identify 104 out of scope companies in our sample, we can logically expect that there are out of scope companies in the population that were not sampled. The 3,423 represents an estimated number of in-scope companies and because it is based on a random sample, we can compute a margin of error of plus or minus 42 companies around that estimate.

academics and other knowledgeable individuals who focus on issues related to investor confidence and the auditor attestation requirement. Moreover, we interviewed small public companies exempt from auditor attestation but who nonetheless complied with the requirement. In addition, we reviewed surveys undertaken by various government agencies and organizations to gauge the impact of the auditor attestation on investor confidence. We conducted a focused review of the research related to Section 404(b) of the Sarbanes-Oxley Act and summarized the recent studies most relevant to our objective. The empirical research discussed may have limitations, such as accuracy of measures and proxies used. We reviewed published works by academic researchers, government agencies, and organizations with expertise in the field. We performed our searches from September 2012 through May 2013. We assessed the reliability of these studies for use as corroborating evidence and found them to be reliable for our purposes. We also included questions in our web-based survey to large and small public companies of various industries about this matter. Lastly, we reviewed relevant federal securities laws, the Securities Act of 1933 and the Securities Exchange Act of 1934.[12]

We conducted this performance audit from May 2012 to July 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[12]Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2012)); Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78pp (2012)).

Appendix II: Comments from the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

June 20, 2013

A. Nicole Clowers
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Clowers:

Thank you for the opportunity to review the draft report required by Section 989I of the Dodd-Frank Wall Street Reform and Consumer Protection Act. We greatly appreciate the valuable insight that the Government Accountability Office ("GAO") has provided regarding the importance of reliable financial reporting, including the importance of internal control over financial reporting ("ICFR") and the independent audit function.

The draft report correctly identifies that a non-accelerated filer that does not voluntarily include in its annual report an attestation report from its auditor on ICFR is not required to disclose this fact explicitly. We believe that this fact can be easily determined by investors from information that is already disclosed in the annual report. An issuer is required to indicate its filing status on the cover page of its annual report, clearly disclosing whether the issuer is a non-accelerated filer and, therefore, exempt from the auditor attestation requirement. Further, SEC rules require any issuer that includes an auditor's attestation report on ICFR in its annual report, whether the attestation report is voluntary or required, to include a statement that the attestation report is included in the annual report.[1] As a result, non-accelerated filers that voluntarily provide an attestation report are readily identified.

In addition, investors can also find information regarding the existence of an opinion on ICFR by looking at the audit report in the issuer's filing. For example, when the auditor is engaged to opine on ICFR, Public Company Accounting Oversight Board ("PCAOB") standards permit the auditor to issue a combined report, which would contain both an opinion on the financial statements and an opinion on ICFR.[2] If the auditor chooses to issue a separate attestation report on ICFR, PCAOB standards require an explicit statement that the issuer's ICFR

1 *See* Item 308(a)(4) of Regulation S-K.

2 *See* PCAOB Auditing Standard ("AS") No. 5, paragraph 86.

A. Nicole Clowers
Page 2

has been audited.[3] In the case of either combined or separate reports, the fact that the auditor opined on ICFR is clearly disclosed in the auditor's report on the financial statements.

When the auditor is not engaged to opine on ICFR, PCAOB standards permit the auditor to also include in its report on the financial statements an explicit statement of this fact and that the auditor does not express an opinion on ICFR.[4] The PCAOB has announced that, as part of its standard-setting agenda, it plans to propose changes to the auditor's reporting model later in 2013. As part of this project, we understand that the PCAOB staff intends to recommend that the PCAOB seek specific feedback on requiring, as opposed to permitting, these explicit statements.

We remain dedicated to continuously evaluating and improving our disclosure requirements and to making sure that investors have the information they need to make informed investment decisions. We appreciate GAO's attention to these important issues, and we would like to thank you and your staff for your work.

Sincerely,

Paul Beswick
Chief Accountant
Office of the Chief Accountant

Lona Nallengara
Acting Director
Division of Corporation Finance

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3 *See* PCAOB AS No. 5, paragraph 88.

4 *See* PCAOB AU Section 9550.10.

Appendix III: GAO Survey of Accelerated Filers and Nonaccelerated Filers

Survey of Accelerated and Non-accelerated Filers Regarding Section 404(b) of the Sarbanes-Oxley Act

United States Government Accountability Office

Introduction

The U.S. Government Accountability Office (GAO) is the independent evaluation and investigative agency of the Congress. As statutorily mandated by Section 989I of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), GAO is currently conducting a study with respect to the auditor attestation requirement under Section 404(b) of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act) for securities issuers whose market capitalization is less than $75 million (referred to as non-accelerated filers). Section 989G(a) of the Dodd-Frank Act amended the Sarbanes-Oxley Act to permanently exempt non-accelerated filers from having to comply with the auditor attestation requirement under Section 404(b) of the Sarbanes-Oxley Act.

Your participation in the survey will help us provide a comprehensive report to the Congress. In reporting the results of the survey, we will not tie individual responses to you or your company by name. GAO generally reports the results of surveys in aggregate. While GAO may incorporate individual responses in the report, we will do so in a manner designed to ensure that individual respondents cannot be identified. Further, GAO will not otherwise release individually identifiable versions of responses unless required by law or requested by a member of Congress.

To learn more about completing the survey, printing your responses, and whom to contact if you have questions, click here for help.

Thank you in advance for your cooperation.

Section 1 - Background Information

1. Please provide contact information for the primary person completing this questionnaire in the event we need to contact you to clarify a survey response.

Name:	
Company:	
E-mail address:	
Office telephone:	
Title	[none]
Specify other title:	

Please note: In this questionnaire, the fiscal year is defined by how **your company** defines its fiscal year.

2. In what year did your company **first file** an annual report, such as a Form 10-K or Form 20-F, with the Securities and Exchange Commission (SEC)?

- Before fiscal year 2007
- During fiscal year 2007
- During fiscal year 2008
- During fiscal year 2009
- During fiscal year 2010
- During fiscal year 2011
- During fiscal year 2012
- No response

3. Which best describes your company?

- A U.S. issuer
- A foreign private issuer
- No response

Please note: For question 4, total market capitalization is the dollar amount of the total number of shares outstanding (non-affiliates and affiliates) multiplied by the share price.

4. What is your company's total market capitalization as of the most recently ended fiscal year?

$

Section 2 - Fiscal Year and Filing Status

5. What is the end date of the fiscal year for which you last filed a Form 10-K or 20-F or 40-F?
(Please enter month, day, and year. For example, if your company's fiscal year ended on December 31, 2011, and it filed its Form 10-K in February 2012, you would enter December 31, 2011.)

Month	Day	Year
[none]	[none]	[none]

6. On Form 10-K or 20-F, which box for SEC registrant filing status did your company check for each of the following fiscal years? *(Select one answer in each row.)*

	Large accelerated filer	Accelerated filer	Non-accelerated filer	Small reporting company	Not sure	Not applicable
FY 2004	○	○	○	○	○	○
FY 2005	○	○	○	○	○	○
FY 2006	○	○	○	○	○	○
FY 2007	○	○	○	○	○	○
FY 2008	○	○	○	○	○	○
FY 2009	○	○	○	○	○	○
FY 2010	○	○	○	○	○	○
FY 2011	○	○	○	○	○	○
FY 2012	○	○	○	○	○	○

Please note: Throughout this questionnaire, **ICFR** will refer to "internal control over financial reporting."

7. In which of the following fiscal years did your company have an independent audit of the effectiveness of its ICFR? *(Select one answer in each row.)*

	Yes	No	Not sure	Not applicable
FY 2004	○	○	○	○
FY 2005	○	○	○	○
FY 2006	○	○	○	○
FY 2007	○	○	○	○
FY 2008	○	○	○	○
FY 2009	○	○	○	○
FY 2010	○	○	○	○
FY 2011	○	○	○	○
FY 2012	○	○	○	○

8. Which one of the following statements best describes your company?

○ We have always been a non-accelerated filer or a smaller reporting company
○ We were once a non-accelerated filer or a smaller reporting company, but are no longer a non-accelerated filer or small reporting company

- ○ We were once a large accelerated filer or accelerated filer, but are no longer a large accelerated filer or accelerated filer
- ○ We have always been a large accelerated filer or accelerated filer *(Click here to go to Section 3 - Total Audit Fees)*
- ○ Not sure *(Click here to go to Section 3 - Total Audit Fees)*

8a. Did your company ever **voluntarily** have an independent audit of the effectiveness of its ICFR?

- ○ Yes - *Continue with question 8b.*
- ○ No *(Click here to skip to question 8e)*
- ○ Not sure *(Click here to skip to question 8e)*

8b. For which of the following reason(s) did your company choose to voluntarily have an independent audit of the effectiveness of its ICFR? ***(Select all that apply.)***

- ☐ To evaluate the effectiveness of the company's internal controls
- ☐ To instill audit committee confidence in the company's ICFR
- ☐ To ensure the quality of the company's financial reporting
- ☐ To improve company's ability to raise capital
- ☐ To instill investor confidence in the company
- ☐ To detect or prevent potential fraud
- ☐ For other reason(s) - *If selected, specify other reason(s) below.*

Please specify other reason(s):

8c. Since fiscal year 2004 has your company ever **stopped having a voluntary audit** of the effectiveness of its ICFR?

- ○ Yes - *Continue with 8d.*
- ○ No *(Click here to skip to question 8e)*
- ○ Not sure *(Click here to skip to question 8e)*

8d. *(If yes)* For what reason(s) did your company choose to stop having a voluntary audit of the effectiveness of its ICFR? ***(Select all that apply.)***

- ☐ We no longer qualified for an exemption from an audit of the ICFR
- ☐ They are too costly
- ☐ They are too time-consuming
- ☐ We believe it was useful to do once but not on an annual basis
- ☐ We believe that non-accelerated filers and smaller reporting companies should be exempt from this requirement
- ☐ For other reason(s) - *If selected, specify other reason(s) below.*

Please specify other reason(s):

8e. For the next fiscal year, does your company plan to voluntarily have an independent audit of the effectiveness its ICFR?

- ○ Yes *(Click here to go to Section 3 - Total Audit Fees)*
- ○ No - *Continue with question 8f.*
- ○ Not sure *(Click here to go to Section 3 - Total Audit Fees)*

8f. *(If no)* For what reason(s) does your company **not** plan to have a voluntary audit of the effectiveness of its ICFR for the next fiscal year? ***(Select all that apply.)***

- ☐ We no longer qualified for an exemption from an audit of the ICFR
- ☐ They are too costly
- ☐ They are too time-consuming

- ☐ We believe it was useful to do once but not on an annual basis
- ☐ We believe that non-accelerated filers and smaller reporting companies should be exempt from this requirement
- ☐ For other reason(s) - *If selected, specify other reason(s) below.*

Please specify other reason(s):

Section 3 - Total Audit Fees

This next section of the survey is about the total fees your company paid its independent auditor for both the audit of the financial statements and the audit of ICFR, as well as factors that may have caused those fees to change from year to year.

You should **exclude** from your total audit fees any fees paid for non-audit services (such as tax compliance services or audit services that are not related to filings of your company's financial statements with the SEC, such as fees to audit an employee benefit plan).

9. What is the **total amount of audit fees paid** to your independent auditor and the **approximate amount of fees paid for the audit of ICFR** for fiscal years 2009, 2010, 2011, and 2012? *(Enter whole dollar amounts. If unknown, check box.)*

	Total audit fees	Approximate fees for audit of the ICFR	
FY 2009	$	$	☐ Unknown
FY 2010	$	$	☐ Unknown
FY 2011	$	$	☐ Unknown
FY 2012	$	$	☐ Unknown

10. **For fiscal year 2011**, if the following events or factors occurred, what impact did they have on your company's total audit fees (relative to what these fees would have been had these events or factors not occurred)? *(Select one answer in each row.)*

Event or factor

	Not applicable, event did not occur	Caused higher fees	Had little or no impact	Caused lower fees	Not sure
a. Material acquisition or divestiture	○	○	○	○	○
b. Restatement of company's prior financial statements	○	○	○	○	○
c. Change in use by your independent auditor or the work of others (e.g., management, internal audit)	○	○	○	○	○
d. Adoption of new accounting and auditing pronouncements (separate from Auditing Standard No. 5)	○	○	○	○	○
e. Change of auditor	○	○	○	○	○
f. Change in the number of hours the auditor needed to conduct the audit due to changes other than those listed above	○	○	○	○	○
g. Other event or factor - *If applicable, specify other event/factor below.*	○	○	○	○	○
h. Other event or factor - *If applicable, specify other event/factor below.*	○	○	○	○	○

Please specify other event or factor for row g:

Please specify other event or factor for row h:

Section 4 - Fees Related to the ICFR Audit

In this section, we will ask questions about the costs of compliance that are associated with the independent audit of ICFR, which can be measured as dollar fees or time spent. In answering these questions, you should exclude from consideration the costs of the traditional financial statement audit.

Audit background and perception

11. **Between the fiscal year 2011 and fiscal year 2012 independent audits of your company's ICFR,** how much of an impact, if any, did the following factors have on the **amount of time spent by the independent auditor to conduct the audits**? *(Select one answer in each row.)*

	Not applicable	Caused a decrease in time spent	Had little or no impact on time spent	Caused an increase in time spent	Not sure
a. Change in the number of accounts and processes selected for audit	○	○	○	○	○
b. Change in the number of areas for which the independent auditor conducted walk-throughs	○	○	○	○	○
c. Change in the number of controls selected and/or the nature, timing, and extent of control testing by the auditor	○	○	○	○	○
d. Change in the number of company locations selected for audit	○	○	○	○	○
e. Change in the degree of the auditor's use of the work of others (e.g., management, internal audit)	○	○	○	○	○
f. Change in the number of hours the auditor needed to conduct the audit due to changes other than those listed above	○	○	○	○	○
g. Other change - *If applicable, specify other change(s) below.*	○	○	○	○	○

Please specify other change(s) for row g:

Use of COSO or other frameworks

The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) Internal Control-Integrated Framework is a framework for designing and evaluating systems of internal control.

12. What internal control framework does your company primarily use to comply with Section 404(a) and 404(b) of the Sarbanes-Oxley Act?

○ COSO
○ Another framework - *If selected, identify the other framework below.*
○ Not sure

Please identify the other framework:

COSO's update to its 1992 Internal Control-Integrated Framework - This update is designed to describe how to evaluate internal controls in an operating and regulatory environment that is more complex than it was when the original framework was developed (Note: The updated internal control framework will not take effect until the first quarter of calendar year 2013.)

13. What impact, if any, do you expect the COSO updated internal control framework to have on the amount of time it will take to complete the independent audit of the ICFR **in fiscal year 2013**?

The COSO update will:

- ○ decrease the time greatly
- ○ decrease the time somewhat
- ○ have no effect
- ○ increase the time somewhat
- ○ increase the time greatly
- ○ Not sure

Non-labor costs

14. Approximately how much money did your company spend on software, hardware, travel, and any other **non-labor expenditure** to help you comply with Section 404(b) for fiscal years 2009, 2010, 2011, and 2012? *(Enter whole dollar amounts. If unknown or if not applicable, check the appropriate box.)*

	Approximate amount spent on software, hardware, travel, and other non-labor expenditures		
FY 2009	$	☐ Unknown	☐ Not applicable
FY 2010	$	☐ Unknown	☐ Not applicable
FY 2011	$	☐ Unknown	☐ Not applicable
FY 2012	$	☐ Unknown	☐ Not applicable

Section 5 - Use of Outside Vendors and/or Consultants

Many companies hire outside vendors and/or consultants to assist management in its evaluation of ICFR. These may include Sarbanes-Oxley Act 404 consultants or IT consultants or any other providers of goods and services that were obtained specifically to support the company's 404(a) - management's assessment of ICFR - and 404(b) - independent audit of ICFR - compliance process.

In this survey, **"outside vendors and/or consultants" do not include your company's independent auditor.**

15. For **any** of the following fiscal years - 2009, 2010, 2011, or 2012 did your company **hire an outside vendor and/or consultant** to assist management in its evaluation of ICFR?

- ○ Yes
- ○ No *(Click here to go to Section 6 - Internal Staff Costs)*
- ○ Not sure *(Click here to go to Section 6 - Internal Staff Costs)*

15a. Approximately how much money did your company spend on **fees paid to outside vendors and/or consultants** specifically to help you comply with Section 404(a) and 404(b) for fiscal years 2009, 2010, 2011, and 2012? *(Enter whole dollar amounts. If unknown or if not applicable, check the appropriate box.)*

Section 404(a)	Approximate amount of fees paid to outside vendors and/or consultants to comply with Section 404(a)		
FY 2009	$	☐ Unknown	☐ Not applicable
FY 2010	$	☐ Unknown	☐ Not applicable
FY 2011	$	☐ Unknown	☐ Not applicable
FY 2012	$	☐ Unknown	☐ Not applicable

Section 404(b)	Approximate amount of fees paid to outside vendors and/or consultants to comply with Section 404(b)		
FY 2009	$	☐ Unknown	☐ Not applicable
FY 2010	$	☐ Unknown	☐ Not applicable
FY 2011	$	☐ Unknown	☐ Not applicable
FY 2012	$	☐ Unknown	☐ Not applicable

15b. **For fiscal year 2011**, for each of the services identified below, to what extent, if at all, did your company rely on the services of outside vendors and/or consultants to help it comply with **Section 404(b)** of the independent audit of ICFR? *(Select one answer in each row.)*

	Great extent	Moderate extent	Some extent	No extent	Not sure
a. To identify risks to your company's financial reporting	○	○	○	○	○
b. To identify controls that address identified risks	○	○	○	○	○
c. To document controls identified to address risks	○	○	○	○	○
d. To gather evidence related to testing the operational effectiveness of controls	○	○	○	○	○
e. To test and evaluate the effectiveness of controls	○	○	○	○	○
f. To evaluate deficiencies identified to determine if they were significant deficiencies or material weaknesses	○	○	○	○	○
g. To develop disclosures on SEC filings related to management's assessment	○	○	○	○	○
h. To help you prepare for an independent audit of ICFR	○	○	○	○	○
i. Other services - *If applicable, specify other service(s) below.*	○	○	○	○	○

Please specify other services for row i:

Section 6 - Internal Staff Costs

The next series of questions will focus on your company's internal staff effort required to comply with Section 404(a) and 404(b).

16. For **any** of the following fiscal years - 2009, 2010, 2011, or 2012 did your company **use internal staff** to comply with Section 404(a) and 404(b)?

- ○ Yes
- ○ No (Click here to go to Section 7 - Other Effects of Section 404(b))
- ○ Not sure (Click here to go to Section 7 - Other Effects of Section 404(b))

16a. What was the approximate **total number of internal staff hours** your company spent on the 404(a) and 404(b) compliance process for fiscal years 2009, 2010, 2011, and 2012?
(Enter numbers. If unknown or if not applicable, check the appropriate box.)

Section 404(a)	Approximate total internal staff hours spent on the 404(a) compliance process		
FY 2009	hours	☐ Unknown	☐ Not applicable
FY 2010	hours	☐ Unknown	☐ Not applicable
FY 2011	hours	☐ Unknown	☐ Not applicable
FY 2012	hours	☐ Unknown	☐ Not applicable

Section 404(b)	Approximate total internal staff hours spent on the 404(b) compliance process		
FY 2009	hours	☐ Unknown	☐ Not applicable
FY 2010	hours	☐ Unknown	☐ Not applicable
FY 2011	hours	☐ Unknown	☐ Not applicable
FY 2012	hours	☐ Unknown	☐ Not applicable

16b. **What was the approximate cost for the work done by your company's internal staff** on the 404(a) and 404(b) compliance process for fiscal years 2009, 2010, 2011, and 2012?
(Enter whole dollar amounts. If unknown or if not applicable, check the appropriate box.)

Section 404(a)	Approximate cost for the work done by your company's internal staff on the 404(a) compliance process		
FY 2009	$	☐ Unknown	☐ Not applicable
FY 2010	$	☐ Unknown	☐ Not applicable
FY 2011	$	☐ Unknown	☐ Not applicable
FY 2012	$	☐ Unknown	☐ Not applicable

Section 404(b)	Approximate cost for the work done by your company's internal staff on the 404(b) compliance process		
FY 2009	$	☐ Unknown	☐ Not applicable
FY 2010	$	☐ Unknown	☐ Not applicable
FY 2011	$	☐ Unknown	☐ Not applicable
FY 2012	$	☐ Unknown	☐ Not applicable

Section 7 - Other Effects of Section 404(b)

We are interested in understanding the general impact that complying with Section 404(b) has had on your company and its participation in the capital markets.

17. **Whether or not your company is currently subject to complying with Section 404(b) of the Sarbanes-Oxley Act**, to the best of your knowledge, has complying with Section 404(b) had a positive impact, no impact, or a negative impact on each of the following? *(Select one answer in each row.)*

	Very positive impact	Somewhat positive impact	No impact	Somewhat negative impact	Very negative impact	Not sure
a. The quality of your company's internal control structure	○	○	○	○	○	○
b. The audit committee's confidence in the company's ICFR	○	○	○	○	○	○
c. The quality of your company's financial reporting	○	○	○	○	○	○
d. Your company's ability to prevent and detect fraud	○	○	○	○	○	○
e. Your company's ability to raise capital	○	○	○	○	○	○
f. Investor confidence in your company	○	○	○	○	○	○
g. Efficiency of your company's operation	○	○	○	○	○	○
h. The efficiency of your company's financial reporting process	○	○	○	○	○	○
i. The liquidity of your company's common stock	○	○	○	○	○	○
j. The timeliness of your company financial statement audit	○	○	○	○	○	○
k. Your company's overall firm value	○	○	○	○	○	○
l. Your confidence in the financial reports of other 404(b) compliant companies	○	○	○	○	○	○
m. Other aspect- *If applicable, specify other aspects(s) below.*	○	○	○	○	○	○

Please specify other aspects for row m:

Section 8 - Opinion on Costs and Benefits of Section 404(b)

18. Based on your experience complying with Section 404(b) of the Sarbanes-Oxley Act, do you think the benefits of complying with Section 404(b) outweigh the costs or do the costs outweigh the benefits?

- ○ The benefits greatly outweigh costs
- ○ The benefits somewhat outweigh the costs
- ○ The benefits and costs are about equal
- ○ The costs somewhat outweigh the benefits
- ○ The costs greatly outweigh the benefits
- ○ Not sure (Click here to skip to question 20)

(Click here to skip to question 20)

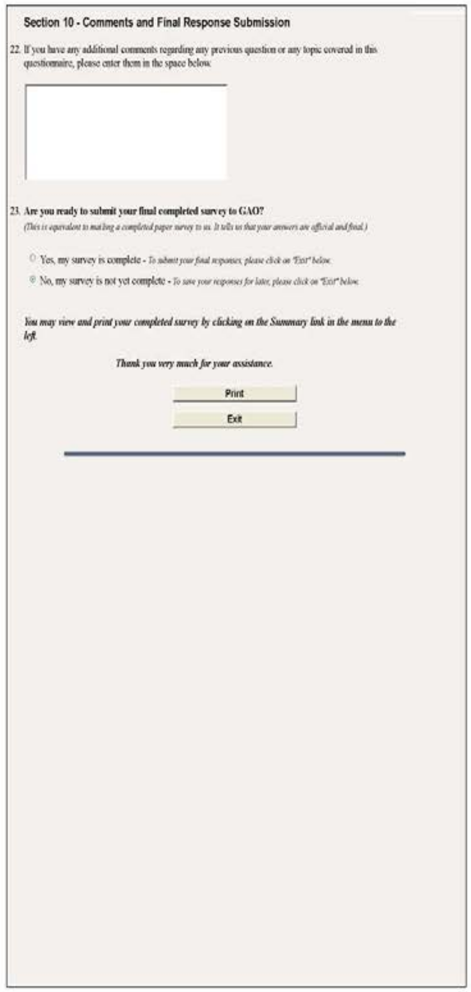
19. What reason(s) led you to the way you answered question 18?

Section 8 - Opinion on Disclosure

20. In your opinion, should issuers that are **exempted** from the 404(b) requirement - to have an independent audit of their ICFR - **be required** to disclose the lack of such an audit to investors such as through a check box disclosure on the front of the Form 10-K?

- Definitely yes
- Probably yes
- No opinion
- Probably no
- Definitely no

21. What reason(s) led you to the way you answered question 20?



Section 10 - Comments and Final Response Submission

22. If you have any additional comments regarding any previous question or any topic covered in this questionnaire, please enter them in the space below.

23. **Are you ready to submit your final completed survey to GAO?**
(This is equivalent to mailing a completed paper survey to us. It tells us that your answers are official and final.)

- Yes, my survey is complete - *To submit your final responses, please click on "Exit" below.*
- No, my survey is not yet complete - *To save your responses for later, please click on "Exit" below.*

You may view and print your completed survey by clicking on the Summary link in the menu to the left.

Thank you very much for your assistance.

Print

Exit

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

A. Nicole Clowers, (202) 512-8678 or clowersa@gao.gov

Staff Acknowledgments

In addition to the contact named above, Karen Tremba, (Assistant Director), James Ashley, Bethany Benitez, William Chatlos, Janet Eackloff, Joe Hunter, Cathy Hurley, Stuart Kaufman, Marc Molino, Lauren Nunnally, Jennifer Schwartz, and Seyda Wentworth made key contributions to this report.

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LETTERS SUBMITTED BY SENATOR TOOMEY

NAHEFFA
National Association of
Health and Educational
Facilities Finance Authorities

June 25, 2018

The Honorable Mike Crapo, Chairman
The Honorable Sherrod Brown, Ranking Member
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the National Association of Health and Educational Facilities Finance Authorities (NAHEFFA), I am writing to express our strong support for S. 1117, the Consumer Financial Choice and Capital Markets Protection Act, which will be considered during the Senate Banking Committee hearing on June 26. This bipartisan legislation would preserve access to an important source of capital and promote low-cost financing for construction and maintenance of health care and educational facilities and other infrastructure investments.

NAHEFFA represents organizations in 34 states which have the authority to provide capital financing for not-for-profit healthcare and higher education institutions as well as other charities. Our borrowing colleges, hospitals, and other institutions depend on money market funds as a source for low-cost capital.

Unfortunately, that access was diminished by a Securities and Exchange Commission (SEC) rule that took effect in October 2016. It prohibits prime and tax-exempt money market funds operating on a stable net asset value (NAV) basis from being offered to investors other than "natural persons." As a result, organizations that require stable value investments had to shift their investments out of those money market funds and into other types of investments that do not support the capital access needs of institutions that provide health care and educational services.

Money market funds are among the largest purchasers of variable rate notes issued by health and education finance facilities authorities. These instruments have a nominal long-term maturity, but the interest rate is adjusted on a daily or weekly basis. As a result, not-for-profit health care and educations institutions are able to undertake long-term infrastructure projects at low short-term rates. Unfortunately, funds that purchase the variable rate notes of the institutions we serve have experienced a nearly 50 percent decline as a result of the SEC's floating NAV rule, thereby driving up the cost of borrowing for investments aimed at improving the quality of health care and education in our country.

NAHEFFA
National Association of
Health and Educational
Facilities Finance Authorities

June 25, 2018
Page 2

We urge you to support enactment of S. 1117 so that we can preserve stable value money market funds as a viable, efficient and cost-effective source of financing for health care and educational institutions. Thank you for your consideration.

Sincerely,

Charles Samuels

Charles Samuels
NAHEFFA General Counsel
Email: casamuels@mintz.com
Telephone: 202-434-7311

ANGEL CAPITAL ASSOCIATION

June 26, 2018

The Honorable Mike Crapo
Chairman, Senate Committee on Banking,
Housing and Urban Affairs
534 Dirksen
Washington, DC 20515

The Honorable Sherrod Brown
Ranking Member
534 Dirksen
Washington, DC 20515

Dear Senators Crapo and Brown:

Thank you for giving us this opportunity to share with you the views of the Angel Capital Association (ACA) on legislative proposals to increase access to capital. On behalf of the 13,000 members of the Angel Capital Association we applaud your bi-partisan approach on one of the most pressing issues impacting our nation – increasing access to capital for small and startup businesses.

The Angel Capital Association is the voice of accredited individual angel investors, angel groups, accredited online platforms and family offices. Angels are accredited individual investors who deploy their own individual money investing in early-stage companies, helping them grow into successful companies. On average in 10 angel investments, 3 to 4 break even, 5 may fail and only 1 delivers high yield results. These investments are risky but one that our members value because of the opportunities they provide for mentoring and making a difference for the American economy. Every year angels invest about $25 billion in more than 70,000 startups. Angels and venture capitalists have invested roughly the same amount of money for many years, although angels invest in 15 times more businesses. An estimated 300,000 angels supported promising companies in every American state.

In addition to providing investment capital, angels often volunteer their own time as mentors, providing support and expertise to grow their companies. Angel-funded startups include Amazon, Home Depot, Google and so many other iconic American brands. Angel investors are found throughout the United States in all states, working to support local startup companies.

Congress has a critical role in increasing economic growth by removing barriers to capital formation. Making it easier for new companies to find the capital they need to grow and expand will not only increase economic growth, it will create high value jobs throughout the country.

Below are the views of ACA on some of the legislation being discussed at today's hearing.

S. 588, Helping Our Angels Lead Our Startups (The HALOS Act).

S. 588 is bi-partisan legislation sponsored by Senators Christopher Murphy, Pat Toomey, Heidi Heitkamp, John Thune, Brian Schatz and Thom Tillis. The HALOS Act seeks to clarify a misinterpretation of the definition of general solicitation by the SEC.

As you know the JOBS Act created general solicitation, allowing entrepreneurs to publicly raise capital for non-public Reg D offerings with safeguards to protect investors. The SEC did not change or modernize the definition of general solicitation, effectively including in that definition traditional "demo days," in which entrepreneurs pitch their companies to potential investors, local economic development officials, academics and others. Because demo days are interpreted as general solicitation, participating entrepreneurs are now responsible for verifying the accreditation status of every potential investor, instead of the previous way of investors self-certifying their accredited status. Many angels are not willing to invest in generally solicited offerings because of these additional verifications.

Demo days have been a firmament of the startup culture in the United States for over thirty years and have always focused on including all members of the innovation ecosystem, from business students to seasoned angel investors and venture capitalists. Entrepreneurs pitched their ideas and privately they engaged in capital raising with individual accredited investors. The demo day itself and the event of having entrepreneurs pitch their ideas traditionally provides practical entrepreneurship education to students and new startups. The SEC has not pointed to any fraud in the traditional demo day or pitch competition model.

The unintended consequence of the general solicitation rules has created confusion among investors and potential legal liability for entrepreneurs, reducing the effectiveness of demo days and reducing capital availability for some startups.

S. 2756, Fair Investment Opportunities for Professional Experts Act

The Dodd-Frank Act updated the definition of an accredited investor to exempt the primary residence from net worth calculations. Dodd-Frank also required the SEC to examine the definition every four years and report on any potential changes. In 2015, SEC staff released a report outlining several steps it could take to dramatically alter the definition of accredited investor. The SEC has yet to act on the recommendations of the staff report.

The Angel Capital Association supports the provision in S. 2756 that would codify the current income ($200,000 for an individual/$300,000 for a couple) and net worth ($1,000,000 excluding a primary residence) thresholds for being considered an accredited investor. Eliminating the regulatory discretion over these thresholds provides needed certainty to the Angel Investors who are the front line of capital formation in our country. In addition, S. 2756 would allow certain people with financial credentials - like passing a Series 7 test - to be considered accredited as well as provide an on-ramp opportunity for people who have investment sophistication and experience but who do not meet the income or net worth thresholds to become accredited. These are common sense ways to safely grow the pool of accredit investors. However, ACA is concerned about the impact of indexing the numerical thresholds for Accredited Investor status to inflation and adjusting them every three years going forward. We understand the intent of ensuring that accredited investors continue to have the financial ability to withstand potential losses from their investments, however if the threshold is raised too quickly it could dramatically shrink the pool of capital available to startup companies. One potential solution would be for the Committee to ensure that any changes in the thresholds continue to allow current accredited investors to remain accredited through a hold harmless or "grandfathering" provision, if any inflationary increases are added to the financial thresholds going forward.

We would be pleased to see the similar House bill become law, as would many other investors, incubators, accelerators, and startups. The House bill would review the wealth and income thresholds every five years instead of the three in S. 588.

Conclusion:

Thank you so much for giving us the opportunity to discuss legislation important to the Angel Capital Association and our 13,000 members. We applaud your bi-partisan approach to considering legislation to increase access to capital for early-stage startup companies. The Angel Capital Association stands with you and all the Members of the Senate Banking Committee as a partner in economic opportunity and job creation. We look forward to the opportunity to work with you and your Committee members as a resource and offer our leadership team as expert witnesses as you delve deeper into the innovation agenda.

Sincerely

Marianne Hudson

Marianne Hudson
Executive Director

ASA American Securities Association

June 26, 2018

Senator Pat Toomey
248 Russell Senate Office Building
Washington, D.C. 20510

Senator Robert Menendez
528 Hart Senate Office Building
Washington, D.C. 20510

Senator Joe Manchin
306 Hart Senate Office Building
Washington, D.C. 20510

Senator Michael Rounds
502 Hart Senate Office Building
Washington, D.C. 20510

RE: **Senate Bill 1117, the Consumer Financial Choice and Capital Markets Protection Act Background and Explanation**

Dear Senator Toomey, Senator Menendez, Senator Rounds, and Senator Manchin:

The American Securities Association (ASA)[1] welcomes the opportunity to submit a letter in support of S. 1117. The ASA's support is derived from the diversity of our membership, the different business models of our membership, and the vast experience our members have transacting in the U.S. municipal bond markets.

This bill addresses an issue of government regulation picking winners and losers. This outcome is not a theoretical debate as the aftermath of the SEC's 2014 Amendments to Rule 2a-7 in October 2016 (to allow for a floating NAV) caused approximately $1.2 trillion of private sector liquidity including roughly 80% of prime and municipal money fund balances to be shifted to U.S. government funds, which were allowed to maintain a stable NAV.

By forcing municipal investors out of prime and tax-exempt funds and into government funds, the SEC's floating NAV rule has increased costs on taxpayers and businesses without any material benefit, other than creating artificial demand for U.S. government deficit spending.

Because of this, municipalities are being forced to seek higher cost borrowing options, reduce their short-term capital consumption, and terminate infrastructure projects that benefit their communities. These options hinder growth, fail to increase prosperity, and disadvantage state and local tax payers.

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[1] The ASA is a trade association that represents the retail and institutional equity capital markets interests of middle market financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans how to create and preserve wealth. The ASA's mission is to promote trust and confidence among investors and support efficient and competitively balanced equity capital markets that advance financial independence, stimulate job creation, and increase prosperity. The ASA has a geographically diverse membership base that spans the Heartland, Southwest, Southeast, Atlantic, and Pacific Northwest regions of the United States.

S.1117 is a broadly bi-partisan bill that fixes the SEC's misguided policy to float the NAV without any detrimental impact on financial stability.

We are pleased to see the committee taking up this bill. We support its swift approval out of committee and its passage by the full Senate in this Congress.

Sincerely,

Christopher A. Iacovella
American Securities Association
Chief Executive Officer

LETTERS SUBMITTED BY SENATOR SCOTT

ES151556

United States Senate
WASHINGTON, DC 20510

March 28, 2014

The Honorable Mary Jo White
Chair
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Dear Chair White,

We write to you as former state and local officials who are concerned about a Securities and Exchange Commission ("SEC" or "Commission") regulatory proposal that would have a deleterious effect on the nation's states and municipalities. The proposal would subject municipal money market funds (MMFs) to a new round of significant reforms and impair the vital role that such funds have played in providing low-cost financing for state and local governments for some 40 years.

Together, the signatories of this letter have decades of municipal and local governance experience, so we know very well how important it is for states and municipalities to have ready access to the capital markets. Municipal MMFs play a primary role in providing such access in a cost-efficient manner for low-cost borrowing needs – for example, to help fund such important local projects and services as schools, hospitals, water treatment plants, public power facilities, highways, and mass transit systems. Municipal MMFs provide more than two-thirds of the short-term funding for such projects and services, making them the largest purchaser of short-term municipal debt. The SEC's proposed regulations will shrink this critical source of funding, leading to significantly higher borrowing costs for states and municipalities – or a reduction of projects and services, with a corresponding decline in the quality of life – or even both.

We note that in 2010 the Commission implemented an extensive array of reforms that substantially improved the resiliency, safety and transparency of all MMFs. The Commission proposed another round of reforms in 2013 involving structural changes that would either require certain funds to abandon their stable $1 net asset value (NAV) and move to a floating NAV or impose redemption restrictions on investors under specified circumstances. The proposal exempts all Treasury and U.S. government MMFs from these proposed structural changes. However, municipal MMFs were not exempted from the proposal even though these funds – like Treasury and U.S. government MMFs – did not exhibit signs of stress during the 2008 crisis. In fact, municipal MMFs remained remarkably stable during the financial crisis of 2008, with only modest outflows.

Municipal MMFs have extraordinary levels of liquidity, short maturities and high credit quality – just like Treasury and U.S. government funds -- and should receive the same exemption from structural reforms. Moreover, municipal MMFs hold only about $270 billion of assets – a very

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small fraction of the $2.7 trillion MMF industry. They simply do not pose a systemic risk to the financial system.

Subjecting municipal MMFs to a floating NAV or redemption restrictions would diminish the desirability of such funds by investors, who value the stability and liquidity they offer. Surveys have found that investor demand for municipal MMFs would decline significantly, setting in motion a series of negative consequences. The amount of short-term municipal debt that MMFs would be able to purchase would dwindle, and there is no readily apparent substitute purchaser for these securities. Debt issuance costs would rise significantly – by a multiple of five or even more, according to some municipal treasurers. Subjecting municipal MMFs to burdensome new regulations will directly – and quite literally – affect Main Street. We have heard directly and loudly from state and local officials in our states about these concerns.

Municipal MMFs have provided generous economic benefits to states, towns, cities and taxpayers alike, without imposing undue risks to the financial system. We are concerned the proposed regulation will place additional stress on municipal budgets by making it more expensive and difficult to raise capital to meet short-term borrowing needs. We ask the Commission to carefully consider the costs of its proposed regulations on state and local governments and whether these costs outweigh any perceived benefit.

Thank you for your attention to these important issues.

Sincerely,

Bob Casey, Jr.
Robert P. Casey, Jr.
United States Senator

Michael B. Enzi
Michael B. Enzi
United States Senator

Michael F. Bennet
Michael F. Bennet
United States Senator

C. B.
Cory A. Booker
United States Senator

John Boozman
John Boozman
United States Senator

Saxby Chambliss
Saxby Chambliss
United States Senator

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Susan M. Collins
United States Senator

Joe Donnelly
United States Senator

Martin Heinrich
United States Senator

John Hoeven
United States Senator

James M. Inhofe
United States Senator

Johnny Isakson
United States Senator

Mike Johanns
United States Senator

Tim Kaine
United States Senator

Angus S. King, Jr.
United States Senator

Joe Manchin, III
United States Senator

Claire McCaskill
United States Senator

James E. Risch
United States Senator

Marco Rubio
United States Senator

Tim Scott
United States Senator

ES151556

Jeanne Shaheen
United States Senator

Mark R. Warner
United States Senator

LETTERS SUBMITTED BY SENATOR COTTON

IPA
Institute for Portfolio Alternatives

June 20, 2018

The Honorable Tom Cotton
124 Russell Senate Office Building
Washington, DC 20510

The Honorable Doug Jones
326 Russell Senate Office Building
Washington, DC 20515

Dear Senators Cotton and Jones:

I am writing to express the Institute for Portfolio Alternatives' (IPAs) support for S. 3004, the Small Business Audit Correction Act of 2018. We appreciate your leadership in advancing this important legislation that provides necessary regulatory relief for small, privately-held, non-custodial broker-dealers (BDs).

For over 30 years the Institute for Portfolio Alternatives has raised awareness of portfolio diversifying investment (PDI) products among stakeholders and market participants, including: investment advisers, public policymakers and the investing public. We support increased access to investment strategies with low correlation to the equity markets: lifecycle real estate investment trusts (Lifecycle REITs), net asset value REITs (NAV REITs), business development companies (BDCs), interval funds and direct participation programs (DPPs). Through advocacy and industry-leading education, the IPA is committed to ensuring all investors have access to real assets and the opportunity to effectively balance their investment portfolios.

Independent broker-dealers, an important part part of the IPA's membership, face increasing regulatory challenges while trying to compete on a level playing field with larger firms. One of those challenges is that current regulations require privately-held, non-custodial brokerage firms to use a Public Company Accounting Oversight Board (PCAOB) registered audit firm for their annual audits. For small, non-custodial BDs it can be challenging to find a PCAOB registered auditor willing to take their business. Very few PCAOB auditors today conduct small firm audits, and charge increasingly high fees and require extensive and complex paperwork of their small firm clients.

Prior to the enactment of the The Sarbanes–Oxley Act of 2002, BDs were required to hire AICPA registered auditors who followed Generally Accepted Auditing Standards (GAAS) when conducting BD annual audits. Following the enactment of Sarbanes-Oxley, BDs irrespective of size are now required to hire a PCAOB-registered auditor who follows the PCAOB-defined set of audit standards, which are markedly different and significantly more complex than GAAS. The reason they are more complex is because they were designed and intended for use in the performance of financial audits of public companies with public shareholders, not privately-owned small businesses.

The PCAOB audit requirement makes sense for large public companies such as Apple, and for BDs that carry customer funds or securities, like large Wall Street wirehouses, because the investing public and markets are potentially at much greater risk from these companies. Conversely, the PCAOB requirements make no sense for privately-held, small non-custodial firms that do not carry customer funds or securities. Currently, a 3-person small business is held to the same standards as a these larger brokerage firms; this is not fair or reasonable. That is why the IPA supports your legislation to eliminate this burdensome requirement, which will allow small, private non-custodial BDs to better compete and serve their customers.

We look forward to working with your offices to pass this simple, common sense legislation that will remove costly burdens on non-custodial BDs. Please contact myself or Anya Coverman, IPA's Senior Vice President, Government Affairs and General Counsel at 202.548.7190 with any questions.

Sincerely,

Anthony Chereso
President & CEO, Institute for Portfolio Alternatives

1455 PENNSYLVANIA AVENUE, NW | SUITE 400
WASHINGTON, D.C. 20004 | 202.548.7190 | IPA.COM

Bond Dealers of America

1909 K Street NW • Suite 510
Washington, DC 20006
202.204.7900
www.bdamerica.org

June 21, 2018

The Honorable Mike Crapo
Chairman
Comm. on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Comm. on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the Bond Dealers of America (BDA), I write to ask for your support and co-sponsorship of the Small Business Audit Correction Act (S. 3004). The BDA is the only Washington, DC based trade association representing the interests of "Main Street" investment firms and banks active predominantly in the U.S. fixed income markets.

S. 3004 would exempt privately held, small non-custodial brokers and dealers in good standing from the requirements to hire a Public Company Accounting Oversight Board (PCAOB) registered audit firm to meet their annual SEA Rule 17a-5 reporting obligation and that the audit firm perform the audit in accordance with PCAOB standards. For these smaller firms, S. 3004 would reinstate the previous regulatory requirements, under which they must file audited financial statements, without a requirement that the audit satisfy PCAOB standards. The one-size-fits-all audit requirements have placed an unfair burden on small businesses, including many BDA member firms, and substantially heightened regulatory burdens onto Main Street broker-dealer firms around the country. S. 3004 would more appropriately tailor the audit requirements while still providing quality customer protections.

Audits conducted in accordance with PCAOB standards delve into granular-level details that have nothing to do with the financial soundness of the small broker-dealers that meet the eligibility requirements for S. 3004 or provide their investors with additional protection. Small broker-dealers that qualify for the exemption do not hold or carry customer funds or securities in their own accounts, choosing instead to have those risks assumed by a larger carrying firm. The PCAOB audit requirement is appropriate and the right fit for public companies and broker-dealers, which carry customer funds or securities, because the investing public and markets are potentially at much greater risk from these companies. Passage of the bill would provide significant and much needed relief for small broker-dealer businesses and access to local, affordable, and sound investment options for your constituents and their communities.

Thank you for your attention to this very important issue.

Sincerely,

M Nicholas

Michael Nicholas
Chief Executive Officer,
Bond Dealers of America

cc: Members of the Senate Committee on Banking, Housing, and Urban Affairs

June 22, 2018

The Honorable Mike Crapo	The Honorable Sherrod Brown
Chairman	Ranking Member
Comm. on Banking, Housing, and Urban Affairs	Comm. on Banking, Housing, and Urban Affairs
United States Senate	United States Senate
Washington, DC 20510	Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown:

The undersigned people, at a minimum and representing small businesses in 49 of 50 states (there are no small brokerage firms headquartered in Wyoming...YET), strongly urge Congress to pass bipartisan legislation, **The Small Business Audit Correction Act of 2018 (S 3004)**, co-sponsored by Senators Tom Cotton (R-AR) and Doug Jones (D-AL), which would request a specific exemption for small, privately held, non-custodial brokers and dealers in good standing from Title One of Sarbanes-Oxley requirement to hire a Public Company Accounting Oversight Board (PCAOB)-registered audit firm.

The legislative and regulatory burden for small businesses in our industry is substantial and small firms are struggling to survive. The signs are clear, small businesses face disproportionate compliance and audit costs and while we have seen increases in regulations and compliance costs, possibly the most unreasonable and unfair is that a small, privately held, non-custodial brokerage firm like ours is required by law and regulation to hire an expensive Public Company Accounting Oversight Board (PCAOB)-registered audit firm.

The PCAOB audit requirement makes sense for public companies and Broker-Dealers that carry customer funds or securities, because the investing public and markets are potentially at much greater risk from these companies. Conversely, the PCAOB requirements make no sense for privately-held, small non-custodial firms that do not carry customer funds or securities. Currently, a 3-person, non-public small business is held to the same standards as Merrill Lynch; this is not right, fair or reasonable.

The one-size-fits-all PCAOB audit standards that were designed for significantly more complex companies, and are priced exorbitantly, have been devastating to small businesses around the country. We simply cannot sustain the human and financial resource burden that these audits place on our small firms, time and money that we should be dedicating to our customers, and we urgently need legislative relief.

Our economy is powered by small business. Our future job growth depends on small business. Our future economic prosperity and competitiveness depends on the ability of our small businesses to innovate and grow into industry leaders across the country. As small business owners and operators across the country, we are asking for your help with this bipartisan issue of helping small businesses. Please help our firms and our community of small businesses by supporting our efforts to get the Small Business Audit Correction Act supported in Committee, brought to the floor of the Senate and House, and passed. Passing this Act will provide significant and much needed relief for small businesses and our customers around the country.

Thank you for your attention to this important issue. If you have any questions or would like additional information, please contact Paige Pierce at paige@paige-pierce.com or (801) 733-9909.

Thank you,

The Small Business Audit Correction Act of 2018

State	Name		Small Firm
AL	Marc	Whitehead	Harbor Financial Services, LLC
AK	John	Guthrie	PT Securities, LLC
AR	Mark	Chambers	Thrasher & Chambers, Inc.
AR	Mary Ellen	Williams	Lieblong & Associates, Inc.
AR	Robert	Keenan	St. Bernard Financial Services, Inc.
AZ	James	Williams	Gogan & Williams
AZ	Bruce	Hilby	Hilby Wilson Inc.
AZ	Patrick	Conway	Fairport Capital, Inc.
AZ	Mark	Howells	M. S. Howells & Co.
CA	Gary	Ching	NPB Financial Group, LLC
CA	Neal	Nakagir	NPB Financial Group, LLC
CA	Shirley	Coria	NNPB Financial Group, LLC
CA	Richard	Leach	Investment Security Corporation
CA	James	Fox	James Fox Securities, Inc.
CA	Morris	Midkiff	Midkiff & Stone Capital Group, Inc.
CA	William	O'Connor	O'Connor & Company Securities Inc.
CA	Audrey	McMahon	Ares Investor Services, LLC
CA	Jose	Portillo	RH Investment Corporation
CA	Howard	Feigenbaum	Sharemaster
CA	Jeffrey	Joslin	Stock Traders
CA	Debra	Draughan	Top Capital Advisors, Inc.
CA	Christopher	Mates	Opus Financial Partners
CA	Stephen	Perry	JCP Securities
CA	Deborah	Higgins	Higgins Capital Management, Inc.
CA	Eduardo	Tovar	Private Portfolio, Inc.
CA	Gary S	Sherwold	G.W. Sherwold Associates, Inc
CA	Eduard	Bagdasarian	Intrepid Investment Bankers LLC
CA	Michael	Kane	Transactiondrivers, LLC
CA	James	Reilly	Stonepine Advisors, LLC
CA	Joseph Delaney	Delaney	J.V. Delaney & Associates
CA	Thomas	Courtney	The Courtney Group, LLC
CA	Kevin Breard	Breard	Breard & Associates Inc CPAs
CA	Thomas	Korzenecki	Grand Avenue Capital Partners, LLC
CA	Allen	Chi	Mainspring Capital Management, LLC
CA	Glen	Haddock	Investment Architects, Inc.
CA	Charles	Painter	Painter, Smith And Amberg Inc.
CA	Maria	Boyd	Investment Placement Group
CA	Lisa	Roth	Tessera Capital Partners LLC
CA	Michelle	Thomas	WBB Securities LLC
CA	Matthew	Miller	WBB Securities, LLC
CA	Richard	Levenson	Western Financial Corporation
CA	Gil	Mogavero	JMP Securities LLC
CA	Randy	Fox	Atel Securities Corporation
CA	Donald	Mahon	Bayridge Securities, LLC

The Small Business Audit Correction Act of 2018

State	Name		Small Firm
CA	Stephen	Nasser	Coit Capital Securities LLC
CA	Lloyd	Leanse	Prager & Co., LLC
CA	Robert	Blum	Robert Blum Municipals, Inc.
CA	Marieanne	Jorajuria	Sharespost Financial Corporation
CA	Alan	Carlisle	Sofi Securities LLC
CA	Weiming	Ho	Integral Financial LLC
CA	Paul	Magnuson	Silicon Valley Securities
CA	Mark	Rogers	N4 Financial, Inc.
CA	Maia	Mcgehee	Mercury Securities, LLC
CA	Shieva	Rajaee	EQIS Capital Management, Inc.
CA	Elizabeth	Collins	Financial Telesis Inc.
CA	Robert	Santos	Arrowroot Partners, LLC
CA	Joseph	Helmer	Caldwell Securities, Incorporated
CA	Nusheen	Javadizadeh	Rjj Pasadena Securities, Inc.
CA	Daniel	Roberts	Roberts & Ryan Investments Inc.
CA	Carolie	Smith	Alamo Capital
CA	Allison	Kent-Aster	Alamo Capital
CA	Jerry	Sanada	Alliance Advisory & Securities, Inc.
CA	Anthony	Duckworth	Investment Architects, Inc
CO	Phil	Antico	Withum Smith And Brown
CO	Blaine	Stahlman	Professional Broker-Dealer Financial Planning, Inc
CO	Chester	Hebert	Colorado Financial Service Corporation
CO	Roberta	Babitz	Andrews Partners
CO	Maxine	Johnson	Kessler Company Investments, Inc.
CO	John	Vansant	Cascade Financial Management, Inc.
CO	Caspar	Ooms	Clearcreek Securities, LLC
CO	Robert	Kessler	Kessler & Company Investments, Inc.
CO	Adam	Carmel	Larimer Capital Corporation
CO	Gordon	Yale	The Yale Group, Inc.
CO	Patricia	Kramer	Destiny Capital Securities Corporation
CO	Stephen	Kohn	Stephen A. Kohn & Associates, Ltd.
CO	Doug	Brode	Christian Financial Services LLC
CT	Robert	Malik	Charter Oak Asset Management, Inc.
CT	Pasquale	Lavecchia	Lavecchia Capital LLC
CT	William	Poon	Casimir Capital L.P.
CT	Michael	Butler	Cfs Securities, Inc.
CT	Eugene	Mauro	Quattro M Securities Inc.
DC	Gregory	Bowes	Albright Securities LLC
DC	John	Mckenna	Hamilton Clark Sustainable Capital, Inc.
DC	Elizabeth	Avery	Kalorama Capital, LLC
DC	Larry	Scully	Scully Capital Securities Corp.
DE	David	Monahan	Coastal Equities
DE	Stephen	Sweeny	Brittingham, Inc.
DE	Charles	Reiling	Coastal Equities, Inc.

The Small Business Audit Correction Act of 2018

State	Name		Small Firm
FL	Sarah	Vegneron	Renaissance Regulatory Services
FL	Jed	Bandes	Mutual Trust Co. Of America Securities
FL	Mark	Beloyan	Tradespot Markets Inc.
FL	Victoria	Ragland	Equity Investment Services, Inc
FL	Ruben	Araneda	Bci Securities, Inc.
FL	Indra	Campbell	Arca Capital Investments, Inc.
FL	David	Wilson	Equifinancial LLC
FL	Susan	Escobio	Southern Trust Securities, Inc.
FL	Clifton	Morris	Mcduffie/Morris Financial Group, Inc.
FL	S. David	Moche	Cornwall Partners, LLC
FL	Michael	Petagna	American Municipal Securities, Inc.
FL	Laura	Crosby-Brown	Stillpoint Capital LLC
FL	Robert	Schlitt	Schlitt Investor Services, Inc.
FL	Karen	Fischer	BG Strategic Advisors
FL	Patricia	Wells	Valor Financial Securities Llc
GA	John	Curran	Fintech Securities
GA	Bruce	Williamson	Fortress Group, Inc.
GA	Marion	Glover	Glover Capital, Inc.
GA	Phyllis	Johnson	H & L Equities, LLC
GA	Aaron	Prisco	Propel Advisory Group, Inc.
GA	Jeffrey	Villwock	Lanier Securities LLC
GA	Caroline	Wisniewski	Bridge Capital Associates, Inc.
GU	Sandra	Mckeever	Asia Pacific Financial Management Group, Inc.
HI	Min Won	Yang	Sun's Brothers Securities Inc.
IA	Timothy	Weitzel	Weitzel Financial Services, Inc.
IA	Harley	Whitfield	American Equity Capital, Inc.
ID	Christopher	Miller	Allegis Investment Services LLC
ID	Ryan	Carlson	American Independent Securities Group, LLC
IL	Darrell	Butler	Billow Butler & Company, LLC
IL	Christopher	Wurtzinger	Forest Securities, Inc.
IL	Margaret	Wiermanski	Rapid Execution Services, LLC
IL	Frederic	Floberg	Tcc Securities, LLC
IL	Donald	Grava	Vgl Global LLC
IL	Gregory	Taunt	Iasg Alternatives, LLC
IL	Randall	Mitterling	Liccar Securities, LLC
IL	Donald	Despain	Despain Financial Corporation
IL	Kevin	Nicol	Nicol Investors Corporation
IL	Kenneth	Sweet	Reliance Worldwide Investments, LLC
IL	James	Correll	Correll Co. Investment Services Corp.
IL	Tim	Ogara	Shannon Advisors LLC
IL	Charles	Millington	Millington Investments, LLC
IL	Frank	Chauner	Chauner Securities, Inc.
IL	Stephen	Mack	Mack Investment Securities, Inc.
IL	Suzanne	Bond	Inland Securities Corporation

The Small Business Audit Correction Act of 2018

State	Name		Small Firm
IN	Melvin	Brewer	Cornerstone Financial Services, Inc.
IN	John	Evanich	Atis, Inc
IN	Randall	Mitterling	Applied Capital, LLC
IN	John	Simmons	Morris Group, Inc.
IN	George	Steel	Planned Investment Co., Inc.
IN	Tom	Faust	Edward Opperman, CPA
IN	Timothy	Peoples	American Equity Investment Corporation
IN	Edward	Opperman	Edward Opperman CPA
KS	John	Stepp	Central States Capital Markets, LLC
KS	Robert	Hamman	First Asset Financial Inc.
KS	Kristopher	Miller	Tandem Securities, Inc.
KS	Margaret	Hornbeck	Truenorth, Inc.
KY	Stanley	Kerrick	Lexington Investment Company, Inc.
LA	Raymond	Thompson	Dorsey & Company, Inc.
LA	Brian	Marcotte	Johnson Rice & Company LLC
LA	Craig	Lewis	Lewis Financial Group, LLC
MA	David	Oldaker	Northern Capital Securities Corporation
MA	H. Don	Drake	O'neil Securities Inc.
MA	Stephen	Oleary	Aeris Partners LLC
MA	Paige	Rand	Agc Partners
MA	Michael	O'hara	Consensus Securities LLC
MA	Sumner	Kaufman	Kaufman & Company, LLC
MA	Tina	Maloney	Winslow, Evans & Crocker, Inc.
MA	Kristin	Kennedy	Wood (Arthur W.) Company, Inc.
MA	Lawrence	Martel	O'Neil Securities, Incorporated
MA	Matthew	Stumpf	AGC Partners
MA	John	Mccarty	Charles River Brokerage, LLC
MA	Richard	Murphy	North Bridge Capital, LLC
MA	Dayna	Gant	Apple Lane Group LLC
MA	Gilbert	Moreira	Donegal Securities, Inc.
MA	William	Mccance	Advisory Group Equity Services Ltd.
MA	Bruce	Fox	Advisory Group Equity Services, Ltd
MA	Sherry	Horn	North Bridge Capital
MD	Craig	Fischer	Atlantic Securities, Inc.
MD	David	Pringle	Fells Point Research LLC
MD	Carol	Greenwald	Potomac Investment Company
MD	Frederick	Holloway	Holloway & Associates, Inc.
MD	Ernest	Brittingham	International Money Management Group, Inc.
MD	Thomas	Schmidt	TLS Financial Services, Inc.
MI	Edward	Schwartz	Gregory J. Schwartz & Co., Inc.
MI	Laura	Powers	Gregory J. Schwartz & Co., Inc.
MI	Gregory	Papesh	Dart, Papesh & Company, Incorporated
MI	Randall	Hansen	Centennial Securities Company, Inc.
MI	Jordan	Powers	Centennial Securities

The Small Business Audit Correction Act of 2018

State	Name		Small Firm
MI	Mark	Cleland	Donnelly Penman & Partners
MI	John	Butterfield	Jack V. Butterfield Investment Company
MI	Thomas	Swiat	Olmsted & Mulhall, Inc.
MI	Jason	Welch	Wwk Investments, Inc.
MI	Erica	Momany	Koehler Financial, LLC
MI	Craig	Adams	Confidential Management Financial Services, Inc.
MN	Todd	Johnson	Cedar Point Capital, LLC
MN	Anthony	Pence	Blacktorch Securities, LLC
MN	Michelle	Sandberg	Dougherty & Company LLC
MN	Jeannie	Sonstegard	Craig-Hallum Capital Group LLC
MN	Tyler	O'neill	Craig-Hallum Capital Group LLC
MN	Kimberly	Chapman	DST Market Services, LLC
MN	Patricia	Bartholomew	Craig-Hallum Capital Group LLC
MN	Basil	Joseph	Van Clemens & Co. Incorporated
MN	Philip	Wright	Brokerbank Securities, Inc.
MN	Todd	Morgan	Stannard Financial Services, LLC
MN	Thomas	Laird	T. E. Laird Securities, LLC
MN	Thomas	Laird	T. E. Laird Securities, LLC
MN	Thomas	Martinson	Martinson & Company, Ltd.
MO	Deborah	Castiglioni	Cutter & Company, Inc.
MO	Boyd	Atteberry	Financial Planning Consultants, Inc.
MO	Leann	Knuth	Labrunerie Group
MO	Alexander	Labrunerie	Labrunerie Financial Services, Inc.
MO	Michael	Dardis	Commerce Brokerage Services, Inc.
MO	Anton	Burch	Burch & Company, Inc
MO	Sandra	Dershem-Vega	Country Club Financial Services, Inc.
MO	Marco	Listrom	Valdes & Moreno, Inc.
MO	Jenifer	Burch	Burch & Company, Inc.
MO	Patrick	Hosty	Neighborly Securities
MO	Dana	Bjornson	George K. Baum Capital Advisors, Inc.
MO	David	Miller	General Securities Corp
MO	Trinity	Lee	Heim, Young & Associates, Inc.
MO	Dean	Young	Heim, Young & Associates, Inc.
MO	Deborah	Mertz	J.A. Glynn Investments LLC
MO	Catherine	Marshall	Huntleigh Securities Corporation
MO	Norman	Conley	J.A. Glynn Investments, LLC
MO	Robert	Chambers	Huntleigh Securities Corp
MO	Robert	Hillard	Arlington Securities, Inc.
MS	James	Coker	Coker & Palmer
MT	Kimberly	Smith	S.G. Long & Company
NC	Larry	Forrest	Smith Point Capital Ltd
NC	Gregory	Leneave	Anderson Leneave & Co.
NC	Charlie	Lucas	Elevation, Llc
NC	Bennett	Cole	Falconbridge Capital Markets, LLC

The Small Business Audit Correction Act of 2018

State	Name		Small Firm
NC	John	Fennebresque	Fennebresque & Co., LLC
NC	Debra	Gilboy	P.R. Gilboy & Associates, Inc.
NC	Robert	Abbott	South Atlantic Enterprises, Inc.
NC	Fredrick	Fisher	Milestone Investments, Inc.
NC	Andrew	Burch	Carolina Securities, Inc.
NC	Melissa	Hoots	Falcon Square Capital, LLC
NC	William	Sykes	Sykes Financial Services LLC
ND	Garry	Pierce	Garry Pierce Financial Services, LLP
ND	Brian	Kraft	Alerus Securities Corporation
NE	Mark	Bell	COR Clearing LLC
NE	Danielle	Hampton	First National Capital Markets
NE	Shirley	Overly	Haley Securities, Inc.
NE	Todd	Engle	Kuehl Capital Corporation
NE	Thomas	Teckmeyer	Teckmeyer Financial Services LLC
NE	John	Detisch	Weitz Securities, Inc.
NH	John	Clarke	1st Bccw Capital Corp
NH	Robert	Macleod	Bigelow Capital Securities LLC
NH	Thomas	Lewry	Curbstone Financial Management Corporation
NH	James	Tovey	JLT Capital Partners LLC
NH	William	King	JSI Transaction Advisors, LLC
NH	Laura	Crosby-Brown	Pronet Financial Partners LLC
NH	Lisa	Durgan	Secure Planning, Inc.
NH	Douglas	Drozdowski	SWN Securities LLC
NJ	Daryl	Hersch	Celadon Financial Group LLC
NJ	David	Sokolower	Repex & Co., Inc.
NJ	Alan	Achtel	Aca/Prudent Investors Planning Corporation
NJ	John	Iannone	Quantex Clearing, LLC
NJ	John	Kuhn	Avatar Capital Group LLC
NJ	Granville	Ungerleider	Whitemarsh Capital Advisors
NJ	Juan	Espinosa	Apto Partners, LLC
NJ	Mark	Furman	Cvf Securities, Inc.
NJ	August	Cellitti	Securevest Financial Group
NJ	Anthony	Cianci	Fox Chase Capital Partners, LLC
NJ	John	Frontero	Cross Point Capital LLC
NJ	Brent	Hippert	Hardcastle Trading Usa LLC
NJ	Andrew	Macinnes	Brilliquid LLC
NJ	Kevin	Hull	Robert A. Stanger & Company, Inc.
NJ	Sheldon	Grodsky	Grodsky Associates, Inc.
NJ	Randolph	Rogers	Merrion Securities, LLC
NM	Randall	Dry	Thornnburg Securities Corp.
NV	Kim	Schmidt	Elmcore Securities
NV	Sean	Deson	Deson & Co.
NV	Felix	Danciu	Elmcore Securities LLC
NY	Bonnie	Mann Falk	Mazars USA LLP

The Small Business Audit Correction Act of 2018

State	Name		Small Firm
NY	Charles	Pagano	Mazars USA LLP
NY	Bruce	Jackson	Carver Cross Securities Corp.
NY	Gary	Hoch	Gary Hoch Agency, Inc.
NY	John	Rogers	Intercoastal Capital Markets, Inc.
NY	Austin	Rybstein	A.C.R. Securities, Inc.
NY	Eytan	Feldman	Old City Securities LLC
NY	George	Reichle	A. P. Securities, Inc.
NY	Parbati	Bhattacharya	Westrock Capital Management, Inc.
NY	Dominick	Scianandre	Hudson Heritage Capital Management, Inc.
NY	Samantha	Larew	Manning & Napier Investor Services, Inc.
NY	Michelle	O'Brien	Manning & Napier Investor Services, Inc.
NY	Maureen	O'Brien	Dynamo Consulting, LLC
NY	Carl	Lanzisera	Federated Securities
NY	Gloria	Scheiman	TG Private Capital
NY	Arthur	Loomis	Northeast Capital & Advisory, Inc.
NY	Richard	Carlesco	Ibn Financial Services, Inc.
NY	James	Westmacott	Westco Investment Corp.
NY	Barbara	Fulcher	Westco Investment Corp
NY	Wendy	Lanton	Lantern Investments
NY	Dawn	Haye	Glaucon Capital Partners, LLC.
NY	Janice	Parise	Sddco Group
NY	Robert	Aufhauser	Aufhauser Securities, Inc.
NY	Robert	Solomon	Beekman Securities, Inc.
NY	W. Stewart	Cahn	Cahn Capital Corp.
NY	Ronald	Pasternak	Dbot Ats, Llc
NY	E. Magnus	Oppenheim	E. Magnus Oppenheim & Co. Inc.
NY	Howard	Spindel	Surya Capital Securities LLC
NY	Garfield	Miller	Aegis Energy Advisors Corp.
NY	Victor	Park	Alternative Asset Investment Management Securities
NY	Kevin	Hourihan	Ashmore Investment Management (Us) Corporation
NY	Oliver	Cromwell	Bentley Securities Corporation
NY	Ian	Green	Brokerageselect
NY	W. Stewart	Cahn	Cahn Capital Corp.
NY	Michael	Steinberg	Ccb International Overseas (Usa) Inc.
NY	David	Wong	Colonial Securities, Inc.
NY	Michael	Kraus	HT Capital Securities, LLC
NY	John	Kiremidjian	NB Markets, Inc.
NY	Gerhard	Summerer	DZ Financial Markets LLC
NY	Jason	Eveleth	Exane, Inc.
NY	Scott	Abrams	Financo Securities, LLC
NY	Ilan	Lessick	Gmp Securities, LLC
NY	William	Hunnicutt	Hunnicutt & Co. LLC
NY	Henry	Marshall	Hunter, Keith, Marshall & Co., Incorporated
NY	Bishen	Pertab	ICICI Securities Inc.

The Small Business Audit Correction Act of 2018

State	Name		Small Firm
NY	Howard	Spindel	IIP Securities LLC
NY	Robert	Rabinowitz	J.H. Darbie & Co., Inc.
NY	John	Loofbourrow	John W. Loofbourrow Associates, Inc.
NY	Leslie	Feldman	Eureka Capital Markets, L
NY	Sam	Kopkind	Lwpartners Capital Group LLC
NY	Lawrence	May	May Capital Group, LLC
NY	Lawrence	Walther	Maybank Kim Eng Securities Usa Inc.
NY	George	Ramirez	Mfr Securities, Inc.
NY	Ann-Marie	Baker	Muzinich Capital LLC
NY	Steven	Perlstein	Mvp Financial, LLC
NY	Robert	Snider	Omnicap, LLC
NY	Ruben	Brache	Opening Night Capital, LLC
NY	Kenneth	Boyar	Palico LLC
NY	Patrick	O'meara	Profor Advisors
NY	Robert	Hackel	R. F. Lafferty & Co., Inc.
NY	Larry	Kimmel	Redburn (Usa) Llc
NY	M. Allison	Steiner	Rhone Group Advisors LLC
NY	Martin	Pollock	Eurekacap Partners Inc
NY	David	Deblase	South Street Securities LLC
NY	Steven	Jafarzadeh	Stonehaven, LLC
NY	Michael	Cardello	Terra Capital Markets LLC
NY	George	Schinkel	The Klein Group, LLC
NY	William	Robertson	Tm Capital Corp.
NY	Charles	Gerber	Triumph Global Securities, Ltd.
NY	David	Shields	Wellington Shields & Co., LLC
NY	Michael	Lowenberg	White Mountain Capital, LLC
NY	David	Rappaport	Investec Securities (US). LLC
NY	John	Luttenberger	Macro Risk Advisors LLC
NY	Alexander	Mack	Middlemarch Securities LLC
NY	Robert	Kent	Morningside Securities, LLC
NY	Brent	Hippert	Ashton Stewart & Co.
NY	John	Parmigiani	Alllied Millenial
NY	Michael	Mangieri	Seven Points Capital, LLC
NY	Andrew	Epstein	Gordon, Haskett
NY	Raymond	Mendez	Brittany Capital Group, Inc.
NY	Constantine	Baris	Longship Alternative Asset Mgmt, LLC
NY	Robert	Stearns	Longship Alternative Asset Management
NY	Steven	Rubenstein	Arrow Investments, Inc.
NY	Allan	Goldstein	Trade Informatics Llc
NY	Joseph	Lanzisera	Excel Securities & Associates, Inc.
NY	Scott	Zollo	Mutual Funds Associates Inc.
NY	Wayne	Holly	Sage, Rutty & Co., Inc.
NY	John	Maceranka	The Windmill Group, Inc.
NY	Olaf	Neubert	Topcap Partners, Inc.

The Small Business Audit Correction Act of 2018

State	Name		Small Firm
NY	John	Pisapia	Chelsea Financial Services
NY	Teresa	Davies	Burke & Quick Partners LLC
NY	Philip	Coombe	Coombe Financial Services, Inc.
NY	Jerome	Keenan	International Equity Services, Inc.
NY	Steven	Blecher	Morgan Joseph Triartisan, LLC
NY	Stephen	Distante	Vanderbilt Securities, LLC
OH	Frank	Panzeca	Clark Schaefer Hackett CPAs & Advisors
OH	Peter	Nerone	Great American Advisors, Inc.
OH	John	Seibert	J. D. Seibert & Company, Inc.
OH	Salvatore	Raffa	Northcoast Research Partners
OH	Martin	Rizzo	Northcoast Research Partners, LLC
OH	Timothy	Henahan	Baker & Co., Inc.
OH	Dock	Treece	Treece Financial Services Corp.
OH	Melissa	Henahan	Baker & Co., Inc
OK	James	Oplotnik	Access Investments, Inc.
OR	Edward	Curiel	DLX Financial Group, L LLC
OR	Richard	Goud	HP Securities, Inc.
OR	William	Campbell	Equilibrium Capital Services, LLC
OR	Tanya	Durkee Urbach	Paulson Investment Company, LLC
PA	Leona	Robinson	Robinson & Robinson, Inc.
PA	Betty	Rainier	Beaconsfield Financial Services, Inc.
PA	Richard	Rainier	Beaconsfield Financial Services, Inc.
PA	Mark	Karbiner	Pm Securities, LLC Dba Phoenix Capital Resources
PA	John	Marsden	JRM Securities
PA	Peter	Engelbach	J. Alden Associates, Inc.
PA	Steven	Segal	Park City Capital, Inc.
PA	Kevin	Kornfield	Kevin Hart Kornfield & Company, Inc.
PA	James	Oconnor	Bestvest Investments, Ltd.
PA	Dale	Pope	Mercap Securities, LLC
PA	Mark	Cresap	Cresap, Inc.
PA	W. Dean	Karrash	Burke, Lawton, Brewer & Burke, LLC
PA	Brian	Anderson	Nestlerode & Loy, Inc.
PA	Judy	Loy	Nestlerode & Loy, Inc.
PR	John	Holman	Esh Capital, LLC
PR	Ramon	Thomas	Rd Capital Group, Inc.
RI	Wilson	Saville	Barrett & Company
RI	David	Izzi	Brown, Lisle/Cummings, Inc.
RI	Karen	Bacon	Diversified Resources, LLC
SC	Nelson	Arrington	V. M. Manning & Co., Inc.
SC	Edward	Dowaschinski	Dunes Securities Corporation
SC	Edward	Dowaschinski	Dunes Securities Corporation
SC	Joan	Grava	Palmetto Advisory Group
SC	Derrick	Grava	Palmetto Advisory Group
SC	Kenneth	Wilson	TRC Markets LLC

The Small Business Audit Correction Act of 2018

State	Name		Small Firm
SD	Gregory	Wilson	Variable Investment Advisors, Inc.
TN	Raymond	Brandon	Brandon Investments, Inc.
TN	Dan	Mayfield	Sanderlin Securities, Llc
TN	Lisa	James	Wiley Bros Aintree Capital, LLC
TN	Joel	Oertling	Avondale Partners, LLC
TN	James	Murphy	Avondale Partners, LLC
TN	David	Wiley Iii	Wiley Bros.-Aintree Capital, LLC
TN	David	James	Pnfp Capital Markets, Inc.
TN	Thomas	Altfillisch	Western Equity Group, Inc.
TX	Byron	Treat	Great Nation Investment Corporation
TX	Dante	Fichera	Independent Investment Bankers, Corp.
TX	Jason	Rivera	Acc Securities, LLC
TX	Billy	Sims	Brazos Securities, Inc.
TX	Travis	Duren	Crescent Securities Group, Inc.
TX	Chad	Bailey	Guidestone Financial Services
TX	Lewis	Fisher	L. B. Fisher & Company
TX	Daniel	Dooley	Maplewood Investment Advisors, Inc.
TX	John	Mauldin	Mauldin Securities, LLC
TX	James	Davis	Texas Corporate Capital Advisors
TX	Katherine	Cook	Venovate Marketplace, Inc.
TX	Jeremy	Halpin	Guidestone Financial Services
TX	Carla	Wright	Signal Securities, Inc.
TX	Ivan	Singleton	Signal Securities, Inc.
TX	Robert	Bagley	Bullish Bob Bagley Securities, Inc.
TX	Robbi	Jones	Kipling Jones & Co., Ltd.
TX	Melinda	Legaye	Moody Securities, LLC
TX	Kevin	Regan	RHCA Securities, LLC
TX	William	Wilson	SP Securities LLC
TX	William	Hoover	Steward Securities Group LLC
TX	Patrick	Smetek	Sunbelt Securities, Inc.
TX	Randal	Ferguson	First Western Securities, Inc.
TX	Craig	Kilpatrick	First Western Securities
TX	Ilonka	Nobles	Nobles & Richards, Inc.
TX	Linde	Murphy	ME Allison & Co
TX	Christopher	Allison	M. E. Allison & Co., Inc.
TX	David	Mcnally	Mcnally Financial Services Corporation
TX	Heather	Nelson	ME Allison
TX	Tiffany	Fisher	CNS Securities, LLC
TX	Richard	Sandow	Forte Securities LLC
TX	Timothy	Kohn	Investors Brokerage Of Texas, Ltd.
TX	Scott	Taylor	Scott T. Taylor, Ltd.
UT	James	Dowd	North Capital Private Securities Corporation
UT	Stephanie	Holt	North Capital Private Securities
UT	Betsy	Voter	Michael Best

The Small Business Audit Correction Act of 2018

State	Name		Small Firm
UT	Eric	Vos	Moreton Capital Markets LLC
UT	Paige	Pierce	PSP Consulting
VA	Francis	Stiff	Cheval Capital, Inc.
VA	Robert	Mann	First Georgetown Securities, Inc.
VA	Shawn	Mclaughlin	Mclaughlin Ryder Investments, Inc.
VA	Jennifer	Szaro	Lara, May & Associates, LLC
VA	Nicole	Saunders	Northwest Financial Advisors
VA	Robert	Moreschi	Eastern Point Securities, Inc.
VA	Kenneth	Smither	Smither & Company Capital Markets, LLC
VA	Donna	Arles	Wealthforge Securities
VA	Mark	Dempsey	Navy Federal Brokerage Services, LLC
VT	Brian	Mckenna	D.B. Mckenna & Co., Inc.
VT	Donald	Mckenna	D. B. Mckenna & Co., Inc.
WA	Dick	Smith	Down Under Enterprises
WA	Michael	Keller	FSIC
WA	James	Humbard	A&A Securities LLC
WA	Sean	Grubb	Northwest Investment Advisors, Inc.
WA	Tim	Vorpahl	Vorpahl Wing Securities
WI	Richard	Peterson	Liberty Investment Counsel, Ltd.
WI	Tami	Strang	Buttonwood Partners, Inc.
WI	Mari	Buechner	Coordinated Capital Securities, Inc.
WI	Gennady	Bekasov	Hewins Brokerage Services, LLC
WI	Michael	Losse	Willow Cove Investment Group, Inc.
WV	Jacob	Doyle	Financial West Group
WV	Timothy	Bidwell	Hazlett, Burt & Watson, Inc.
WV	Ami	Shaver	United Brokerage Services, Inc.
WV	Rose	Wilson	Wesbanco Securities, Inc.

Dave Banerjee, CPA
Accountancy Corporation

June 21 2018

Tom Cotton
Senator R-AR
Attn: Economic Policy Counselor Kyle Hauptman

Re The Small Business Audit Correction Act [Bill Numbers: H.R. 6021 and S. 3004]

Dear Senator Cotton

The regulatory burden for small businesses in my industry is substantial, and it has gotten to a point where small firms are struggling to survive. While we have seen increases in regulations in many areas, possibly the most unreasonable and unfair is that a small, privately held, non-custodial brokerage firm like mine is required by law and regulation to hire an expensive Public Company Accounting Oversight Board (PCAOB) registered audit firm.

Prior to Sarbanes-Oxley, as amended by Dodd-Frank, Broker/Dealers were required to hire AICPA registered auditors who followed Generally Accepted Auditing Standards (GAAS) when conducting Broker/Dealer annual audits. Following the enactment of the Acts Broker/Dealers, irrespective of size, are required to hire a Public Company Accounting Oversight Board-registered auditor who follows the PCAOB-defined set of audit standards, which are markedly different and significantly more complex than GAAS. The reason they are more complex is because they were designed and intended for use in the performance of financial audits of public companies with public shareholders, not privately-owned small businesses like ours. We request a return to the more appropriate AICPA Generally Accepted Auditing Standards.

The PCAOB audit requirement makes sense for public companies like Apple and Broker/Dealers that carry customer funds or securities, like Morgan Stanley, because the investing public and markets are potentially at much greater risk from these companies. Conversely, the PCAOB requirements make no sense for privately-held, small non-custodial firms that do not carry customer funds or securities - companies like mine. Currently, a 3-person small business is held to the same standards as Merrill Lynch; this is not right, fair or reasonable.

The one-size-fits-all PCAOB audit standards that were designed for significantly more complex companies, and are priced accordingly, have been devastating to small businesses around the country. We simply cannot sustain the human and financial resource burden that these audits place on our small firms and we need legislative relief, and we need it now.

The Small Business Audit Correction Act [H.R. 6021 and S. 3004] therefore requests a specific exemption for privately held, small non-custodial brokers and dealers in good standing from the Title One of Sarbanes-Oxley requirement to hire a Public Company Accounting Oversight Board (PCAOB)-registered audit firm.

CPA services for broker-dealers and securities professionals
21860 Burbank Blvd, Ste 150 • Woodland Hills CA 91367
Phone (818) 657-0288 • Fax ((818) 657-0299 • www.davebanerjee.com

Dave Banerjee, CPA
Accountancy Corporation

My firm is a small business owner and operator located in California and I am asking for your help with this bipartisan issue of helping small businesses. Please help the community of small businesses by supporting our efforts to get the Small Business Audit Correction Act included in the HFSC June markups, supported in Committee [H.R. 6021 and S. 3004], brought to the floor of the House and Senate, and passed. Passing this Act will provide significant and much needed relief for small businesses and our customers in our state and around the country.

Thank you,

Dave Banerjee, CPA
PCAOB Audit firm with expertise in Broker-Dealers

CPA services for broker-dealers and securities professionals
21860 Burbank Blvd, Ste 150 • Woodland Hills CA 91367
Phone (818) 657-0288 • Fax ((818) 657-0299 • www.davebanerjee.com

Congress of the United States
Washington, DC 20515

February 14, 2011

Mr. Jim Doty, Chairman
PCAOB
1666 K Street, NW
Washington, DC 20006

Mr. Lew Ferguson Board Member
PCAOB
1666 K Street, NW
Washington, DC 20006

Mr. Daniel L. Goelzer, , Board Member
PCAOB
1666 K Street, NW
Washington, DC 20006

Mr. Jay Hanson, Board Member
PCAOB
1666 K Street, NW
Washington, DC 20006

Mr. Steven B. Harris, Board Member
PCAOB
1666 K Street, NW
Washington, DC 20006

Re: Proposed Interim Rulemaking for Auditors of Broker-Dealers

Dear Board Members:

We are writing to you as both Members of Congress and as Certified Public Accountants (CPAs). Each of us has extensive experience as CPAs and we are well aware of the important role the Public Company Accounting Over sight Board (PCAOB) plays in ensuring that federal regulation of the accounting and auditing professions is effective and appropriate.

We are writing today regarding Section 982 of the Dodd-Frank Act, which grants broad new authority to the PCAOB regarding the oversight of auditors of broker-dealers. As the Board undertakes its interim rulemaking under this provision, we ask that you carefully weigh the need to extend additional protections to investors while also avoiding the creation of new onerous, excessive regulations on small CPA firms. Since this is an entirely new area of oversight for the PCAOB, we applaud your decision to undertake an interim rule first to gather important information and expertise before proposing a final rule.

In this initial interim rule, we believe that the most appropriate route for the PCAOB to take is to focus your oversight on those audit firms whose broker-dealer clients have access to investor funds. These so called "clearing, carrying, and custodial" broker-dealers are the class of auditors for whom there is a broad consensus for additional regulation, as well as the most perceived benefit to investors. We urge the PCAOB to act quickly to begin an effective and targeted inspection program over these auditors.

It is also important to note that during congressional consideration of Section 982, there was considerable debate about what benefits, if any, would be achieved by extending PCAOB oversight to auditors of introducing broker-dealers – those broker-dealers with no access to client monies. This interim rule period is an appropriate time for the PCAOB to study that question. We believe that along with an interim rule covering auditors of clearing, carrying, and custodial broker-dealers, the PCAOB should undertake a study on the benefits of registering and inspecting auditors of introducing broker-dealers, without actually extending such regulatory oversight to this class of auditors until the study is done.

We would like to caution you that it would be a mistake, at this juncture, to extend regulation over auditors of introducing broker-dealers when there is insufficient evidence about the benefits of such regulation, and there is the very real chance that a final rule may not ultimately include this class of audit firms. The issuance of an overly broad interim rule would create regulatory uncertainty, impede business decisions, and add unwarranted costs to these small businesses. However, once a study has been done, and the PCAOB has publicly articulated the merits of a second rule focused on oversight of auditors of introducing broker-dealers, then it would be practical to proceed. If the case is compelling, then in consultation with Congress, and with input from affected parties, the PCAOB should move to a rulemaking on auditors of introducing broker-dealers. If the case is not strong, you will have averted imposing regulatory chaos, unforeseen costs, and lost time and resources on those small firms whom it was ultimately deemed inappropriate to cover.

If the PCAOB follows our counsel and undertakes this due diligence study, we ask you also to engage the Securities and Exchange Commission and the Financial Industry Regulatory Authority, in their role as principal regulators of broker-dealers. We understand that there may be certain instances where introducing broker-dealers may have brief and limited access to investor funds. In situations such as these, where there is a heightened opportunity for fraud or malfeasance, rather than extending new oversight over the auditors of introducing broker-dealers, a fresh discussion of associated risks to investors may more appropriately solicit ideas for stronger safeguards by the principal regulators themselves.

In closing, we are pleased that Mr. Goelzer, in his capacity as Acting Chairman, has publicly acknowledged on repeated occasions that it would be inappropriate to treat all auditors of broker-dealers identically. We share his perspective and hope that all of you, both the recently appointed members as well as the longer serving members, will allow that philosophy to guide your approach.

We look forward to working with you as this rulemaking proceeds, as well as on other important topics which affect the accounting and auditing professions.

Respectfully,

Rep. Lynn Jenkins

Rep. Collin C. Peterson

Rep. Michael K. Conaway

Rep. Brad Sherman

Rep. John Campbell

Rep. Jim Renacci

Rep. Steven Palazzo

Rep. Bill Flores

FINANCIAL SERVICES INSTITUTE | VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

June 20, 2018

The Honorable Mike Crapo
Chairman
Senate Banking Committee
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Senate Banking Committee
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Brown:

The Financial Services Institute (FSI)[1] and the 35,000 independent financial advisors and over 100 independent financial service firms that we represent strongly support S. 3004: Small Business Audit Correction Act of 2018. This bill would exempt privately-held, small, non-custodial brokers-dealers in good standing from the requirement to hire a Public Company Accounting Oversight Board (PCAOB)-registered audit firm to meet their annual reporting obligation and would instead reinstate the previous regulatory audit requirements. Currently, the Dodd-Frank Act requires all investment brokers and dealers, irrespective of size, to hire a PCAOB-registered audit firm to conduct audits using significantly more complex guidelines designed for larger, public companies. We believe this legislation will provide much-needed regulatory relief to small broker-dealers by exempting them from the most onerous audit requirements. Therefore, we urge the Committees to support S. 3004, ensuring that small broker-dealers can continue to operate without these unnecessary burdens.

The broker-dealer community in the financial services industry consists of large companies, mid-sized firms, and small businesses. As of November 2017, the small business community consisted of 3,425 firms all employing 150 registered reps or fewer. Ten years ago, the approximately 1,000 more of these small businesses in our industry than there are today, but the crush of regulatory burdens, including the PCAOB-registered audit firm requirement, has led to their demise. The remaining small firms are feeling this impact especially hard as audit fees rise due to the smaller pool of audit firms. The impact is felt throughout the country as these Main Street businesses struggle to remain viable.

On behalf of our members, FSI appreciates your time in considering support for the S. 3004: Small Business Audit Correction Act of 2018. For all of the above reasons, FSI applauds both Senators Cotton and Jones for introduction of S. 3004: Small Business Audit Correction Act of 2018 in the 115th Congress, and we hope that the Senate Banking, Housing and Urban Affairs Committee will consider this worthwhile piece of legislation that will provide much-needed regulatory relief to small investment brokers across the United States.

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[1] The Financial Services Institute (FSI) is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has successfully promoted a more responsible regulatory environment for more than 40,000 independent financial advisors, and more than 100 independent financial services firms who represent upwards of 160,000 affiliated financial advisors. We effect change through involvement in FINRA governance as well as constructive engagement in the regulatory and legislative processes, working to create a healthier regulatory environment for our members so they can provide affordable, objective advice to hard-working Main Street Americans.

If you have any questions, please contact J. Maurice Jackson, Director of Legislative Affairs, at (202) 499-7220.

Sincerely,

Dale E. Brown, CAE

President & CEO

cc: Members of the Senate Banking, Housing and Urban Affairs Committee

LETTERS SUBMITTED BY SENATOR TILLIS

BioND

Bioscience Association of North Dakota
Center of Innovation
Suite 500, Rm 500
4200 James Ray Drive
Grand Forks, North Dakota 58202
Ph. : 701-317-2483
biosciencend@gmail.com
www.ndbio.com

June 21, 2018

Senator Heidi Heitkamp
516 Hart Senate Office Building
Washington, DC 20510

Dear Senator Heitkamp,

I write to you in strong support of S.2126, the "Fostering Innovation Act." I encourage you to support this important legislation, which would build on the success of the JOBS Act and support growing biotech companies as they continue to develop life-saving medical advances.

The Fostering Innovation Act would support the growth of emerging biotechs by reducing the cost of burdensome regulations. Specifically, the bill would create a targeted five-year exemption from Sarbanes-Oxley (SOX) Section 404(b) for JOBS Act companies that are still pre-revenue when the IPO on-ramp expires. The Fostering Innovation Act would extend the exemption for years 6 through 10 after a company's IPO if it maintains average annual revenues below $50 million and a public float below $700 million.

The JOBS Act has stimulated more than 260 biotech IPOs by reducing compliance costs and increasing companies' access to investors. The law's five-year SOX 404(b) exemption saves newly public biotech companies up to $1 million annually—but most research and development-intensive innovators will still be pre-revenue when their exemption expires. Every dollar spent on regulatory burdens that do not provide meaningful information to investors is a dollar unnecessarily diverted from the lab.

The Fostering Innovation Act builds on the JOBS Act's successful move away from one-size-fits-all compliance burdens. We believe it will help sustain the growth of the biotech industry in our state and support the search for the next generation of medical breakthroughs.

Thank you for your hard work on behalf of North Dakota's emerging biotech innovators, and we look forward to working with you on this important issue.

Sincerely,
Richard Glynn
Richard Glynn
Executive Director
Bioscience Association of
North Dakota
701-317-2483
biosciencend@gmail.com

BioOhio

June 21, 2018

Senator Sherrod Brown
713 Hart Senate Office Building
Washington, DC 20510-3505

Dear Senator Brown,

I write to you in strong support of S.2126, the "Fostering Innovation Act." I encourage you to support this important legislation, which would build on the success of the JOBS Act and support growing bio companies as they continue to develop life-saving medical advances.

In Ohio, over 78,800 employees, the highest on record, work with at least 3,336 bioscience-related organizations, manufacturing products, providing essential services, or researching the next breakthrough at 4,165 facilities found in 81 of 88 counties, generating $5.83 billion of payroll at an average wage of $73,897. All six Ohio regions have experienced growth in the bioscience industry and play a role in advancing critical discoveries.

The vast majority of these companies are small businesses, even though many do not yet generate product revenue—they are still investing in vital research in the lab or the clinic and are years away from having a product on the market.

The Fostering Innovation Act would support the growth of these companies by reducing the cost of burdensome regulations. Specifically, the bill would create a targeted five-year exemption from Sarbanes-Oxley (SOX) Section 404(b) for JOBS Act companies that are still pre-revenue when the IPO on-ramp expires. The Fostering Innovation Act would extend the exemption for years 6 through 10 after a company's IPO if it maintains average annual revenues below $50 million and a public float below $700 million.

The JOBS Act has stimulated more than 260 biotech IPOs by reducing compliance costs and increasing companies' access to investors. The law's five-year SOX 404(b) exemption saves newly public biotech companies up to $1 million annually—but most research and development-intensive innovators will still be pre-revenue when their exemption expires. Every dollar spent on regulatory burdens that do not provide meaningful information to investors is a dollar unnecessarily diverted from the lab.

The Fostering Innovation Act builds on the JOBS Act's successful move away from one-size-fits-all compliance burdens. We believe it will help sustain the growth of the biotech industry in our state and support the search for the next generation of medical breakthroughs.

Thank you for your hard work on behalf of Ohio's emerging biotech innovators, and we look forward to working with you on this important issue.

Sincerely,

John F. Lewis Jr., President & CEO

1275 Kinnear Road, Columbus, OH 43212
Telephone # (614) 675-3686, Fax # (614) 675-3687
www.bioohio.com

June 22, 2018

Senator Mark Warner
703 Hart Senate Office Building
Washington, DC 20510

Dear Senator Warner,

I write to you in strong support of S.2126, the "Fostering Innovation Act." I encourage you to support this important legislation, which would build on the success of the JOBS Act and support growing biotech companies as they continue to develop life-saving medical advances.

Virginia is home to 1,876 companies and research organizations in the biotechnology, bioscience industry employing 23,926 Virginians at an average annual salary of $80,018. The vast majority of these companies are small businesses that do not yet generate product revenue—they are still investing in vital research in the lab or the clinic and are years away from having a product on the market.

The Fostering Innovation Act would support the growth of these emerging biotechs by reducing the cost of burdensome regulations. Specifically, the bill would create a targeted five-year exemption from Sarbanes-Oxley (SOX) Section 404(b) for JOBS Act companies that are still pre-revenue when the IPO on-ramp expires. The Fostering Innovation Act would extend the exemption for years 6 through 10 after a company's IPO if it maintains average annual revenues below $50 million and a public float below $700 million.

The JOBS Act has stimulated more than 260 biotech IPOs by reducing compliance costs and increasing companies' access to investors. The law's five-year SOX 404(b) exemption saves newly public biotech companies up to $1 million annually—but most research and development-intensive innovators will still be pre-revenue when their exemption expires. Every dollar spent on regulatory burdens that do not provide meaningful information to investors is a dollar unnecessarily diverted from the lab.

The Fostering Innovation Act builds on the JOBS Act's successful move away from one-size-fits-all compliance burdens. We believe it will help sustain the growth of the biotech industry in our state and support the search for the next generation of medical breakthroughs.

Thank you for your hard work on behalf of Virginia's emerging biotech innovators, and we look forward to working with you on this important issue.

Sincerely,

Jeff Gallagher

Jeff Gallagher, CEO, Virginia Bio

virginiabio 800 E. LEIGH STREET, SUITE 14 RICHMOND, VA 23219-1534 T 804.643.6360 F 804.643.6361 vabio.org

Institute for Portfolio Alternatives

June 20, 2018

The Honorable Thom Tillis
185 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Catherine Cortez Masto
204 Russell Senate Office Building
Washington, DC 20515

Dear Senators Tillis and Cortez Masto:

On behalf of the Institute for Porfolio Alternatives (IPA), I write to express our support for S. 2756, "Fair Investment Opportunities for Professional Experts Act." We appreciate your leadership on this legislation, which will broaden the definition of accredited investor in a safe and responsible manner.

For over 30 years the Institute for Portfolio Alternatives has raised awareness of portfolio diversifying investment (PDI) products among stakeholders and market participants, including: investment advisers, public policymakers and the investing public. We support increased access to investment strategies with low correlation to the equity markets: lifecycle real estate investment trusts (Lifecycle REITs), net asset value REITs (NAV REITs), business development companies (BDCs), interval funds and direct participation programs (DPPs). Through advocacy and industry-leading education, the IPA is committed to ensuring all investors have access to real assets and the opportunity to effectively balance their investment portfolios.

S. 2756 updates and modernizes the current definition of "accredited investor" under Section 2(a)(15) of the Securities Act of 1933, by, in part, codifying the income and net worth requirements under Rule 501 of Regulation D and indexing them for inflation based on the Consumer Price Index on a going-forward basis. The bill also recognizes that people with certain credentials such as registered broker-dealers, investment advisers and their representatives, should qualify as accredited investors, and provides the U.S. Securities and Exchange Commission ("Commission") with authority to qualify additional categories of investors as accredited based on education, job or professional experience and/or cetain non-financial thresholds.

Many IPA members offer private placement products to accredited investors under Regulation D. We strongly support legislation that will expand the current definition of accredited investor in a manner that is safe and responsible, while not unduly shrinking the current pool of eligible investors. We believe that S. 2756 is a substantial step in that direction. The IPA strongly supports provisions that allow people with a Series 7, CFA or other credentials to be considered accredited for the purpose of being able to invest in non-public offerings. We also support the bill's provision that would allow the Commission to include persons based on factors such as financial sophistication, net worth, knowledge, experience in financial matters, or amount of assets under management.

The IPA would also support an inclusion in the bill of a reasonable belief standard in its codification of income and net worth standards. A reasonable belief standard currently exists in Rule 501(a) of Regulation D—allowing an issuer to establish a reasonable belief as to an investor's accredited investor status—and should be consistent in S. 2756.[1] We also support a grandfathering provision to allow existing investors to participate in future investments in the same issuer to avoid dilution of their current investments.[2]

The IPA looks forward to working with your offices to support this sensible bill's passage. If the IPA may be of any assistance, please do not hesitate to contact me or Anya Coverman, IPA's Senior Vice President, Government Affairs and General Counsel at 202.548.7190 with any questions.

Sincerely,

Anthony Chereso
President & CEO, Institute for Portfolio Alternatives

[1] Accredited investor shall mean any person who comes within any of the following categories, *or who the issuer reasonably believes comes within any of the following categories*, at the time of the sale of the securities to that person..." 17 CFR 230.501 (emphasis added). Under Rule 506(c), unlike other Rules under Regulation D, the issuer must "verify" accredited investor status.

[2] The SEC staff made a recommendation to grandfather issuers' existing investors that are accredited investors under the current definition with respect to future offerings of their securities. *See* SEC Report on the Review of the Definition of "Accredited Investor," December 18, 2015, *available at* https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf.

MONTANA BIOSCIENCE ALLIANCE

June 21, 2018

Senator Jon Tester
311 Hart Senate Office Building
Washington, DC 20510

Dear Senator Tester,

I write to you in strong support of S.2126, the "Fostering Innovation Act." I encourage you to support this important legislation, which would build on the success of the JOBS Act and support growing biotech companies as they continue to develop life-saving medical advances.

The Fostering Innovation Act would support the growth of emerging biotechs by reducing the cost of burdensome regulations. Specifically, the bill would create a targeted five-year exemption from Sarbanes-Oxley (SOX) Section 404(b) for JOBS Act companies that are still pre-revenue when the IPO on-ramp expires. The Fostering Innovation Act would extend the exemption for years 6 through 10 after a company's IPO if it maintains average annual revenues below $50 million and a public float below $700 million.

The JOBS Act has stimulated more than 260 biotech IPOs by reducing compliance costs and increasing companies' access to investors. The law's five-year SOX 404(b) exemption saves newly public biotech companies up to $1 million annually—but most research and development-intensive innovators will still be pre-revenue when their exemption expires. Every dollar spent on regulatory burdens that do not provide meaningful information to investors is a dollar unnecessarily diverted from the lab.

The Fostering Innovation Act builds on the JOBS Act's successful move away from one-size-fits-all compliance burdens. We believe it will help sustain the growth of the biotech industry in our state and support the search for the next generation of medical breakthroughs.

Thank you for your hard work on behalf of Montana's emerging biotech innovators, and we look forward to working with you on this important issue.

Sincerely,

Sharon Peterson

Executive Director, P.O. Box 1773, Billings, Montana 59103

Whitehorse Executive Center
1255 Whitehorse-Mercerville Road
Building B - Suite 514
Trenton, New Jersey 08619
T 609.890.3185 F 609.581.8244

June 22, 2018

Senator Bob Menendez
528 Hart Senate Office Building
Washington, DC 20510-3001

Dear Senator Menendez,

I write to you in strong support of S.2126, the "Fostering Innovation Act." I encourage you to support this important legislation, which would build on the success of the JOBS Act and support growing biotech companies as they continue to develop life-saving medical advances.

New Jersey is home to 2,877 companies and research organizations in the biotechnology, bioscience industry employing 93,293 New Jerseyans at an average annual salary of $144,178. The vast majority of these companies are small businesses that do not yet generate product revenue—they are still investing in vital research in the lab or the clinic and are years away from having a product on the market.

The Fostering Innovation Act would support the growth of these emerging biotechs by reducing the cost of burdensome regulations. Specifically, the bill would create a targeted five-year exemption from Sarbanes-Oxley (SOX) Section 404(b) for JOBS Act companies that are still pre-revenue when the IPO on-ramp expires. The Fostering Innovation Act would extend the exemption for years 6 through 10 after a company's IPO if it maintains average annual revenues below $50 million and a public float below $700 million.

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The Fostering Innovation Act builds on the JOBS Act's successful move away from one-size-fits-all compliance burdens. We believe it will help sustain the growth of the biotech industry in our state and support the search for the next generation of medical breakthroughs.

Thank you for your hard work on behalf of New Jersey's emerging biotech innovators, and we look forward to working with you on this important issue.

Sincerely,

Debbie Hart
President and CEO

June 21, 2018

Senator Joe Donnelly
720 Hart Senate Office Building
Washington, DC 20510

Dear Senator Donnelly,

I write to you in strong support of S.2126, the "Fostering Innovation Act." I encourage you to support this important legislation, which would build on the success of the JOBS Act and support growing biotech companies as they continue to develop life-saving medical advances.

Indiana is home to 1,680 companies and research organizations in the biotechnology, bioscience industry employing 54,418 Indianans at an average annual salary of $89,982. The vast majority of these companies are small businesses that do not yet generate product revenue—they are still investing in vital research in the lab or the clinic and are years away from having a product on the market.

The Fostering Innovation Act would support the growth of these emerging biotechs by reducing the cost of burdensome regulations. Specifically, the bill would create a targeted five-year exemption from Sarbanes-Oxley (SOX) Section 404(b) for JOBS Act companies that are still pre-revenue when the IPO on-ramp expires. The Fostering Innovation Act would extend the exemption for years 6 through 10 after a company's IPO if it maintains average annual revenues below $50 million and a public float below $700 million.

The JOBS Act has stimulated more than 260 biotech IPOs by reducing compliance costs and increasing companies' access to investors. The law's five-year SOX 404(b) exemption saves newly public biotech companies up to $1 million annually—but most research and development-intensive innovators will still be pre-revenue when their exemption expires. Every dollar spent on regulatory burdens that do not provide meaningful information to investors is a dollar unnecessarily diverted from the lab.

The Fostering Innovation Act builds on the JOBS Act's successful move away from one-size-fits-all compliance burdens. We believe it will help sustain the growth of the biotech industry in our state and support the search for the next generation of medical breakthroughs.

Thank you for your hard work on behalf of Indiana's emerging biotech innovators, and we look forward to working with you on this important issue.

Sincerely,

Kristin Jones

Kristin Jones, President and CEO
Indiana Health Industry Forum

LETTERS SUBMITTED BY SENATOR MENENDEZ

COUNTY OF BERGEN

OFFICE OF THE COUNTY EXECUTIVE

One Bergen County Plaza, Room 580, Hackensack, NJ 07601-7076

(201) 336-7300 Fax: (201) 336-7304

countyexecutive@co.bergen.nj.us

James J. Tedesco III

County Executive

June 2, 2017

The Honorable Josh Gottheimer, United States Congressman
United States House of Representatives
213 Cannon House Office Building
Washington, DC 20515
SENT VIA EMAIL to Christopher Tully (Chris.Tully@mail.house.gov)

Dear Congressman Gottheimer,

The New Jersey Association of County Administrators expressed its support for a re-introduction of legislation aimed at addressing the Securities and Exchange Commission (SEC) modifications to SEC Rule 2a-7 of *the Investment Company Act of 1940.* The County supports the Association in this endeavor. The Legislation changes the net asset value (NAV) accounting methodology for money market mutual funds (MMMF) from stable to floating and imposes liquidity fees and redemption gates on investors of these funds.

The Association relied on the hallmark stable NAV feature in a variety of ways. Many governments invest in money market funds because of their secure nature, simple accounting methodology and management, and liquidity – all features that are necessary for governments to protect public funds, access cash and pay obligations. Changing the main feature of these funds to a floating NAV has created administrative and costly burdens to governments, large and small, in addition to having governments look to other, more expensive investments.

Another problem for state and local governments related to the changes to Rule 2a-7, is the impact it has on governments that issue debt, especially short term debt. Mutual funds are the largest purchasers of short term municipal bonds and due to the changing criteria in this rule the demand for these bonds has diminished. This puts added pressures on state and local governments as it has led to higher debt issuance costs across the country. Policies such as this, potentially hurt governments' ability to fund capital projects with municipal bonds for infrastructure improvements for the benefit of their citizens.

Moreover, state and local governments as investors will continue to be adversely affected by the liquidity fees and redemption gates provisions of Rule 2a-7, which would be imposed during times of fiscal stress. The imposition of liquidity restrictions of MMMF investors have further pushed state and local MMMF investors away from MMMFs due to concerns about liquidity and potential losses that could result during times of fiscal stress. This puts taxpayers' dollars at risk.

For these reasons, the County looks forward to working with you and supporting your efforts to help state and local governments on this money market mutual funds issue and other regulatory and financial matters of mutual interest.

Sincerely,

James J. Tedesco, III
Bergen County Executive

cc: Senator Robert Menendez
Senator Cory Booker
Congressman Bill Pascrell
Congressman Albio Sires

ANIBAL RAMOS, JR.
COUNCIL MEMBER - NORTH WARD
NEWARK, NEW JERSEY 07102

CITY HALL ROOM 304
920 BROAD STREET
NEWARK, NEW JERSEY 07102
(973) 733-5136

May 8, 2017

The Honorable Bob Menendez
United States Senate
528 Hart Senate Office Building
Washington, D.C. 20510

The Honorable Cory Booker
United States Senate
359 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Menendez and Senator Booker,

I wish to express my support for the re-introduction of the Consumer Financial Choice and Capital Markets Protection Act of 2017. Last year, the Securities and Exchange Commission (SEC) adopted amendments to Rule 2a-7 that unintentionally have burdensome consequences on cities such as Newark. The amendment, which changes the net asset value (NAV) accounting methodology for money market mutual Funds (MMMF) and imposes liquidity fees, undermines our ability to invest in important infrastructure projects that are vital to our residents.

As the largest city in the State of New Jersey, Newark will adversely be affected by its inability to issue debt for capital projects that benefit our citizens. Mutual Funds, which hold a large share of short term municipal bonds, are reliable investment tools that empower cities to make significant investments. Without these resources, municipalities are subject to higher debt issuance costs and added fiscal pressure. The Consumer Financial Choice and Capital Markets Protection Act of 2017 alleviates some of these challenges and addresses many of the concerns that push investors away.

Thank you for your leadership in re-introducing and advancing this important piece of legislation. I look forward to working with you and supporting your efforts to defend the ability local governments have to invest in their own communities.

Sincerely,

Anibal Ramos Jr.

Anibal Ramos Jr.,
Councilman

NEW JERSEY ASSOCIATION OF COUNTIES
County Government with a Unified Voice!

ANN M. CANNON
NJAC President
Mercer County Freeholder

JOHN G. DONNADIO
Executive Director

July 28, 2015

Honorable Cory Booker
United States Senator
Gateway One
11-43 Raymond Plaza
West Suite 2300
Newark, NJ 07102

RE: MONEY MARKET FUNDS

Dear Senator Booker:

On behalf of the board of directors of the New Jersey Association of Counties (NJAC), I would like the opportunity to meet with you in person to discuss NJAC's support of S.1802, which would establish the "Consumer Financial Choice and Capital Markets Protection Act of 2015." Senator Pat Toomey *(R-PA)* is the prime sponsor of this important and timely legislation, and we're hoping that you would consider joining senators Joe Manchin *(D-WV)*, Mike Crapo *(D-ID)*, and Robert Menendez as co-sponsors.

NJAC supports S.1802 as recent changes made by the Securities and Exchange Commission (SEC) to the structure of money market funds will substantially impair county governments' ability to manage cash reserves and obtain low-cost financing for critical infrastructure projects. NJAC is particularly concerned with the fact that SEC rule changes in 2014 forced money market funds to abandon their stable $1.00 per-share price and instead "float" net asset values (NAV). NJAC is also concerned that the new rules impose penalties and early redemption fees for the pre-mature withdrawal of funds to meet liquidity needs. As you know, money market funds have proven to be a vital cash management tool for county governments, which until the SEC's untimely rule changes, relied on the stability of managing cash with a consistent principal value. Moreover, county governments counted on the convenience and simplicity that a stable NAV provided for accounting, recordkeeping, and the tax treatment of cash balances accordingly.

150 West State Street · Trenton, New Jersey 08608 · Phone 609-394-3467 · Fax 609-989-8567 · www.njac.org

The dangers of a floating NAV are clear and will undoubtedly lead to increase costs for county governments across New Jersey and the nation. As you also know, money market funds hold more than half of the short-term debt that finances vital public projects such as roads, bridges, airports, water and sewage treatment facilities, hospitals, and low-income housing. Without such financing, local governments may be forced to limit projects, spend more on financing, or increase taxes. Moreover, a floating NAV will force county governments to use bank products that have historically paid lower yields or are much less secure. A floating NAV will also undermine local economies as money market funds hold more than one-third of the commercial paper that businesses use to finance payrolls and inventories. The flight of investors in the wake of a floating NAV will disrupt the supply of short-term credit that employers need to operate.

With this in mind, I look forward to the opportunity of meeting you in person to further discuss the long-term ramifications of a floating NAV and on how S.1802 would reinstitute stability and consistency in money market funds. NJAC is committed to advocating for legislation, regulations, and policy directives that empower county governments to operate more effectively and efficiently. As a non-partisan organization that represents the only true regional form of government in the State with a unified and proactive voice, NJAC is dedicated to advancing innovative programs and initiatives that enhance the level of service provided and save valuable taxpayer dollar. Thank you for your time and consideration, and please do not hesitate to contact me at (609) 394-3467 with any questions or concerns.

Very truly yours,

John G. Donnadio, Esq.
Executive Director

cc: Matthew Chase, Executive Director, National Association of Counties
Deborah Cox, Legislative Director, National Association of Counties

COUNTY OF HUDSON

OFFICE OF THE COUNTY ADMINISTRATOR

ADMINISTRATION ANNEX

567 PAVONIA AVENUE

JERSEY CITY, NEW JERSEY 07306

THOMAS A. DE GISE
COUNTY EXECUTIVE

ABRAHAM ANTUN
COUNTY ADMINISTRATOR

TELEPHONE
(201) 795-6100

FAX
(201) 795-6520

July 30, 2015

Senator Cory Booker
359 Dirksen Senate Office Building
Washington, DC 20510

RE: S.1802

Dear Senator Booker:

As you know, the Securities and Exchange Commission (SEC) made significant changes in 2014 to money market mutual funds that will seriously impair our ability to both manage our cash reserves and obtain low-cost financing for important priorities such as schools, hospitals, public transportation and infrastructure projects. As a former Mayor, you understand the financial challenges New Jersey counties and municipalities face and why it is critical that we have access to simple, efficient and low-cost professional cash management.

Money market funds are a critical cash management tool for us, whether we use the New Jersey Asset & Rebate Management Program or other similar pools offered through banks or other providers. Many New Jersey local units also use the State's Cash Management Fund, a Local Government Investment Pool that while unregulated by the SEC, is subject to the GASB rules and the new SEC regulations will have an adverse impact on these funds as well.

Money market funds are the largest purchasers of short-term municipal debt and provide more than two-thirds of the short-term funding for vital local projects and services. The SEC's changes requiring prime and municipal money market funds to maintain a fluctuating share price, while not affecting government funds, endanger the ability to form and run viable Local Government Investment pools and will negatively impact the capital markets leading to higher borrowing costs. As a result of the SEC's changes, the Wall Street Journal recently published an article about how institutional money is flowing out of prime funds and into Government funds, and that the increase in demand for U.S. government securities will continue to depress the yield of those securities for other investors, including state and local governments. The SEC's changes are a disproportionate reaction to the risk it is trying to prevent, conditions that might only exist in the face of a future fiscal crisis.

By making it more expensive and difficult to meet short-term borrowing costs, the SEC's changes place additional stress on county, municipal, and local authority budgets. State and local government investors met with the SEC Commissioners, wrote comment letters, and testified at Congressional hearings in opposition to the fluctuating share price. Still, the SEC acted to draw an arbitrary distinction between "retail" and "institutional" investors.

Given the strong opposition by investors, state and local governments, and Members of Congress, I urge you to consider supporting and co-sponsoring S.1802 which would establish the "Consumer Financial Choice and Capital Markets Protection Act of 2015". This will preserve the daily liquidity and stable $1 net asset value share price for investors and eliminate the requirement to charge penalty and early redemption fees for pre-mature withdrawal of funds to meet liquidity needs of the local unit.

Sincerely,

Abraham Antun

Office Of The Mayor

CITY OF ELIZABETH, NEW JERSEY

J. CHRISTIAN BOLLWAGE
Mayor

CITY HALL
50 WINFIELD SCOTT PLAZA
ELIZABETH, NEW JERSEY 07201-2462

TEL. 908-820-4170
FAX 908-820-0130

May 16, 2017

Honorable Robert Menendez
United States Senator
One Gateway Center
Suite 1100
Newark, NJ 07102

Dear Senator Menendez:

Please let this letter serve as support for the Consumer Financial Choices and Capital Markets Protection Act of 2017. This Act proposes changes made to the structure of money market funds by the Securities and Exchange Commission (SEC) and will substantially enhance opportunities for local governments to manage cash effectively.

Amendments to Rule 2a-7, which were adopted by the SEC and went into effect in October 2016, have had unintended, adverse impacts on the governing of municipal money market funds. Local governments depended upon these funds to implement improvements as well as increase services through investments in infrastructure projects as well as economic growth and development initiatives. In addition to being a vital cash management tool, municipalities also counted on the convenience and simplicity that a stable NAV provided for accounting, recordkeeping and the tax treatment of cash balances.

The City of Elizabeth is the fourth largest municipality in New Jersey and the Union County Seat. Implementing a comprehensive economic development strategy, the City continues to focus on the attraction, retention and expansion of businesses; revitalization of communities as well as increasing the availability of and accessibility to services, while creating employment and growth opportunities.

Utilizing public and private resources, the City also remains dedicated to maximizing investment and renewal efforts. Building upon its geographic location and direct access to Terminal A of Newark Liberty International Airport, the Port Newark/Elizabeth Marine Terminal, the New Jersey Turnpike, Routes 1&9 as well as two train stations, the City advances development, transportation and quality of life initiatives.

The Consumer Financial Choices and Capital Markets Protection Act of 2017 restores vital options and enhances the ability of municipalities to incorporate innovative strategies, which facilitate progress, promote sustainability and enable efficient and effective services to be delivered.

Thank you for your time and consideration.

Sincerely,

J. Christian Bollwage
Mayor

Office Of The Mayor

CITY OF ELIZABETH, NEW JERSEY

J. CHRISTIAN BOLLWAGE
Mayor

CITY HALL
50 WINFIELD SCOTT PLAZA
ELIZABETH, NEW JERSEY 07201-2462

TEL. 908-820-4170
FAX 908-820-0130

May 16, 2017

Honorable Cory Booker
United States Senator
One Gateway Center
23rd Floor
Newark, NJ 07102

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The Consumer Financial Choices and Capital Markets Protection Act of 2017 restores vital options and enhances the ability of municipalities to incorporate innovative strategies, which facilitate progress, promote sustainability and enable efficient and effective services to be delivered.

Thank you for your time and consideration.

Sincerely,

J. Christian Bollwage
Mayor

CITY OF JERSEY CITY
OFFICE OF THE MAYOR
CITY HALL | 280 GROVE STREET | JERSEY CITY, NJ 07302
P: 201 547 5500 | F: 201 547 5442

STEVEN M. FULOP
MAYOR OF JERSEY CITY

STEVEN M. FULOP
MAYOR OF JERSEY CITY

May 8, 2017

The Honorable Bob Menendez
United States Senate
528 Hart Senate Office Building
Washington, D.C. 20510

The Honorable Cory Booker
United States Senate
359 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Menendez and Senator Booker,

I write this letter to express my support for re-introduction of the Consumer Financial Choice and Capital Markets Protection Act of 2017. Following the unintended and adverse effects of the Securities and Exchange Commission's amendments to Rule 2a-7 governing money markets, remediation proves vital to the economic growth and development of municipalities such as Jersey City.

As the second largest city in the State of New Jersey, Jersey City relies on its ability to fund important infrastructure projects that affect the daily lives of its residents. Investment in vital projects such as new affordable housing and improvements to public safety facilities and roadways is made possible by the secure and reliable nature of money market funds.

Since the adoption of the SEC's amendments to Rule 2a-7 and removal of the stable net asset value feature, money market funds have become a burdensome resource for local governments. The Consumer Financial Choice and Capital Markets Protection Act of 2017 ameliorates these challenges and directly empowers Jersey City and other growing mid-sized cities across the nation to make meaningful investments in infrastructure.

Thank you for introducing this important legislation and working to defend valuable resources for state and local governments.

Sincerely,

Steven M. Fulop
Mayor
City of Jersey City

NEW JERSEY STATE BUILDING & CONSTRUCTION TRADES COUNCIL
- OVER 100 YEARS STRONG -

WILLIAM T. MULLEN
President

DAVID CRITCHLEY
Secretary-Treasurer

VICE PRESIDENTS

JOSEPH EGAN
Electrical Workers

JOSEPH DEMARK, JR.
Sheet Metal Workers

RAYMOND POCINO
Laborers

RICHARD TOLSON
Bricklayers & Allied Crafts

MARC GALLO
Plasterers & Cement Masons

ROBERT CRITCHLEY
Roofers

GREG LALEVEE
Operating Engineers

ANTHONY VALDNER
Teamsters

FRED DUMONT
Insulators & Allied Workers

JAMES CHEW
Boilermakers

LEONARD LEGOTTE
Elevator Constructors

VINCENT LANE
Painters

MICHAEL MALONEY
Pipetrades

JOHN BALLANTYNE
Carpenters

RAYMOND WOODALL
Iron Workers

77 Brant Avenue
Clark, NJ 07066
Ph: (732) 499-0100
Fax: (732) 499-0150
www.njbctc.org

May 3, 2017

The Honorable Bob Menendez
United States Senate
Washington, DC 20510

Dear Senator Menendez:

On behalf of the New Jersey State Building and Construction Trades Council, I am writing to thank you for your support for the Consumer Financial Choice and Capital Markets Protection Act of 2017. This legislation will address the unintended consequences of a burdensome Securities and Exchange Commission (SEC) regulation that has unnecessarily increased the cost of infrastructure projects while stifling local economic growth.

As you know, New Jersey State Building and Construction Trades Council represents over 150,000 hard working men and women throughout the New Jersey, making it one of the largest building trades councils on the East Coast. The New Jersey State Building and Construction Trades Council equips professional craftsmen with the skills that are demanded in today's construction industry.

Your active support for the Consumer Financial Choice and Capital Markets Protection Act is important to union trades men and women because New Jersey has lost out on about billions of tax-exempt funding from money market funds as a result of the SEC rule. Nationally, these funds invested hundreds of billions of dollars in building and maintaining transportation projects, education and hospital facilities, affordable housing, utilities, environmental projects and port facilities.

Thank you for your leadership in introducing and advancing this important legislation. It is an important part of our efforts to increase investment in the roads, bridges and other critical infrastructure projects that are among America's great public achievements and a source of our shared prosperity.

Sincerely,

William T Mullen

William T. Mullen
President

RAS J. BARAKA
MAYOR
NEWARK, NEW JERSEY

May 31, 2017

The Honorable Bob Menendez
United States Senate
528 Hart Senate Office Building
Washington, D.C. 20510

The Honorable Cory Booker
United States Senate
359 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Menendez and Senator Booker,

I write this letter to express my support for the re-introduction of the Consumer Financial Choice and Capital Markets Protection Act of 2017. As you are aware, the recent modifications to the Securities and Exchange Commission (SEC) Rule 2a-7 have unintentionally affected the ability of municipalities to fund important projects that are vital to economic growth. The amendment undermines our ability to be equipped with the proper financial tools that are crucial to enhancing the daily lives of our residents.

As Mayor of the largest city in the State of New Jersey, Newark relies heavily on the secure nature of Money Market Mutual Funds (MMMF) to issue debt for projects such as new affordable housing and improvements to our infrastructure. I'm concerned about the changes to the net asset value (NAV) accounting methodology, which adversely affects our ability to access cash, and the liquidity fees that are being imposed on these funds. Shifting the NAV from stable to floating will be prove to be burdensome for cities such as Newark.

This piece of legislation alleviates some of the fiscal challenges that we face. As a result, we have the ability to shift our focus to implementing a comprehensive economic development strategy. At a time when policies in Washington are geared towards infrastructure improvements, we remain dedicated to maximizing the investment in our city. The Consumer Financial Choice and Capital Markets Protection Act of 2017 will strengthen Newark's financial wellbeing.

I look forward to working with you and supporting your efforts to help cities such as Newark, and I thank you for introducing this important piece of legislation.

Sincerely,

Ras Baraka
Mayor

RAS J. BARAKA
MAYOR
NEWARK, NEW JERSEY

May 31, 2017

The Honorable Bob Menendez
United States Senate
528 Hart Senate Office Building
Washington, D.C. 20510

The Honorable Cory Booker
United States Senate
359 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Menendez and Senator Booker,

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I look forward to working with you and supporting your efforts to help cities such as Newark, and I thank you for introducing this important piece of legislation.

Sincerely,

Ras Baraka
Mayor

OFFICE OF THE MAYOR • 920 BROAD STREET, ROOM 200, NEWARK, NJ 07102 • TELEPHONE (973) 733-6400 • FAX (973) 733-3711 • WWW.CI.NEWARK.NJ.US